APPENDIX A

Internal Revenue Code of 1954:

Sec. 162. TRADE OR BUSINESS EXPENSE.

(a) IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal service actually rendered;

(2) traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, Territory, or possession which he represents in Congress shall be considered his home, but amount expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000.

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(Added September 2, 1958)

(c) IMPROPER PAYMENTS TO OFFICIALS OR EMPLOYEES OF FOREIGN COUNTRIES.—No deduction shall be allowed under subsection (a) for any expenses paid or incurred if the payment thereof is made, directly or indirectly, to an official or employee of a foreign country, and if the making of the payment would be unlawful under

the laws of the United States if such laws were applicable to such payment and to such official or employee.

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(26 U.S.C. 1958 ed., Sec. 162.)

APPENDIX B

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF PUERTO RICO

UNITED STATES OF AMERICA, *Plaintiff*

v.

FELIX BENITEZ REXACH, ET AL, *Defendants*

Civil No. 67-64

(Filed & Entered March 26, 1971)

Opinion

This is an action brought pursuant to Sections 7401, 7402 and 7403 of the Internal Revenue Code and Sections 1340 and 1345 of Title 28 of the United States Code, on request of the Commissioner of Internal Revenue and under the direction of the Attorney General of the United States, filed February 10, 1964 to foreclose liens for income tax, interest and penalties assessed against defendant Félix Benítez Rexach for the calendar years 1959 and 1961, in the total sum of $2,934,098.57. The properties on which foreclosure is sought are the issued and outstanding stock of Escambrón Development Company, a Puerto Rican corporation, a parcel of land located in the Municipality of Bayamón, Puerto Rico, and a debt of said corporation, all belonging and owing at the time to the marital community of Mr. Benítaz Rexach and his wife, Lucienne D'Hotelle de Benítez Rexach, now deceased.

The case was tried before the late Judge Clemente Ruiz Nazario, who retired without having rendered a decision, and the parties by written stipulation submitted the case for decision to the Chief Judge of this Court upon the

complete record of the trial before the late Judge Clemente Ruiz Nazario and additional evidence specified to be presented as follows:

> "(a) Such relevant testimony of Mr. Arnold LaFontaine concerning the records of defendant, Félix Benítez Rexach which were recovered from the Dominican Government after the prior trial and which were made available for inspection and examination of plaintiff, as plaintiff wishes to present.
>
> "(b) Such relevant testimony and other evidence as defendant wishes to present with respect to the alleged losses incurred by defendant as a result of the seizure and receivership of his Dominican business and properties by the Dominican Government from theft and shipwreck, and any depreciation of said properties."

The trial was continued before the Chief Judge and additional evidence presented by the parties pursuant to said stipulation.

In the trial before the late Judge Clemente Ruiz Nazario, the basic pleadings, and virtually all of the evidence consisting of sundry depositions, transcripts of trials and documentary evidence that had been presented in three previous cases between the parties (and described hereinafter) were presented in evidence.

Taxpayer, born in Vieques, Puerto Rico, March 27, 1886, became an American citizen under the provisions of the Act of March 2, 1917, commonly known as the Puerto Rico Organic Act of 1917. He was denaturalized July 14, 1958 by the State Department under Section 349(a) of the Immigration and Naturalization Act (66 Stat. 163), but the Board of Review on the Loss of Nationality on June 25, 1962 held that the causes which lead to this denaturalization were the result of coercion and, hence, null and void *ab initio*.

The taxpayer and his wife, Lucienne D'Hotelle de Benítez Rexach, deceased, were married in Puerto Rico in 1927, and she became a naturalized United States citizen, but by a certificate dated May 20, 1952 approved by the Delegate of the Secretary of State December 23, 1952, the State Department determined that Lucienne D'Hotelle de Benítez Rexach had lost her United States citizenship in 1949 under Section 404(b) of Chapter IV of the Nationality Act of 1940 and denaturalized her as of 1949. Subsequently to said determination she adopted Dominican Nationality. The taxpayer and his wife had never been legally separated or divorced; the first matrimonial domicile was in Puerto Rico, but since 1944 it has been uninterruptedly in the Dominican Republic where taxpayer resided from 1944 to 1962.

Mr. Benítez Rexach, now some 85 years of age, is a licensed engineer with some 50 years experience in the design and construction of harbors and harbor facilities and is recognized as one of the great engineers in connection with harbor works, although he holds no college or university degree. He dredged many of the harbors and constructed and maintained many of the harbor facilities in Puerto Rico, and he designed and constructed the harbors and harbor facilities in the Dominican Republic, including those at the Ports of Santo Domingo, San Pedro de Macoris, Puerto Plata, Barahona, Haina, Boca Chica and Azúa. During a period of some 27 years he dredged no less than 50,000,000 cubic yards of material in the Dominican Republic which, with the construction of harbor facilities and maintenance, embraced contracts with a total price of some $39,000,000.00. He also made the project for the harbor of LaGuaira in Venezuela and is familiar with dredging and harbor work construction in other parts of the world. All of the harbors and harbor facilities constructed by Mr. Benítez Rexach are now in use except the Customs House at the Port of Santo Domingo which was burned during the last revolution in that country. He also designed and constructed a graving dock and a shipyard in the Dominican Republic principally for the repair and maintenance of his

floating equipment, machinery and equipment, consisting of a large hydraulic dredge, numerous barges, derricks, tankers, tugs, supply ships, and other auxiliary equipment for construction, including said graving dock and machine shops with the necessary machinery and equipment, and spare parts and supplies, all of which had an estimated value of approximately $4,000,000.00.

On March 3, 1958 plaintiff brought an action in this Court to foreclose liens on said stock, debt and land for taxes assessed in jeopardy assessments on income of taxpayer for the years 1951 to 1956, both inclusive, derived from harbor constructions contracts with the Dominican Government, amounting in total to $2,354,478.48, including interest and fraud and other penalties. Prior to 1951 such income was not subject to taxation but under the amendments to the Internal Revenue Code plaintiff claimed that it was taxable. Taxpayer contended it was not, but this Court sustained plaintiff's claim. Taxpayer's Washington counsel had rendered an opinion to taxpayer that such income was not taxable and taxpayer had filed no returns for 1951 to 1956. The Commissioner determined that the profits from said contracts amounted to 1/11 of the contract prices which he allocated in equal monthly amounts over the maximum number of months within which each contract was to be completed. In said determination no account was taken of whether the amount of the contract price had been uniformly received per month, the amount of work performed had been done uniformly per month nor whether the amount of cost or expense had been incurred uniformly per month over the maximum contract time for performance. In fact such was not the case, and payments were irregular, the Dominican Government being frequently in arrears in making payment, and in some instances payments were made in advance. In 1961 some $3,000,000.00 was owed him under contracts performed. Taxpayer did not keep or maintain adequate books and records from which the amount of his gross income, deductible expenditures or net income with respect to said contracts could be

determined, and he contended that 1/11 of the contract price was in excess of his profits, that a reasonable profit should not exceed 5% of the contract prices, that he had sustained losses on some contracts. The Court appointed a Special Master to determine the issue, but prior to trial taxpayer accepted the Commissioner's method of determination for the years involved in the assessment. In said case it was stipulated, and the Court so held, that taxpayer's wife, Lucienne D'Hotelle de Benítez Rexach, was a non-resident alien and the Court found and held that under Dominican law she had a vested one-half interest in the income earned from said contracts which was not taxable by the United States. It was also stipulated and held by the Court that taxpayer was entitled to a credit against his United States income tax on the taxable income from such contracts for the amount of the Dominican Gross Receipts tax when assessed by and paid to the Dominican Government. It was also found and held in said case by this Court that the fraud and other penalties were unlawfully assessed, (*United States* v. *Rexach*, 185 F. Supp. 465), and by amended judgment of August 7, 1962 a total of $76,866.01 in taxes with interest was held to be due by taxpayer, which judgment was paid.

In the meantime on June 9, 1959 taxpayer filed federal income tax returns for the year 1957 and the year 1958 (up to July 14, the time at which he was denaturalized by the State Department) in which he made determination of his profits from contracts with the Dominican Government by taking 1/11 of the contract prices and allocating profits just as the Commissioner had done for the years 1951 to 1956, both inclusive, and he reported one-half of said net income therefrom. The Commissioner assessed deficiency and jeopardy assessments for said years on the total of said profits so determined and on February 26, 1960 brought an action in this Court to foreclose liens for income taxes for the years 1957 and 1958 (up to July 14) on income from such contracts and other income amounting in total to $306,363.30 including frand and other penalties. Profits

from said contracts were also determined by the Commissioner as in the said returns in the same manner as for the years 1951 to 1956, both inclusive, and this method of determination was again accepted by taxpayer for the years involved, and again this Court held that taxpayer's wife, a non-resident alien, had a vested one-half interest in said income not subject to taxation by the United States, and dismissed the complaint, the Dominican tax credit assessed and paid being in excess of the amount of the tax under federal law (*United States* v. *Rexach,* 200 F. Supp. 494).

On July 2, 1962, all of the Dominican properties of taxpayer were seized by the Dominiman Government and put in the hands of one Antonio Casals Piñeyro (a Cuban) as sequestrator pursuant to the order of a Dominican Court dated June 20, 1962

> ". . . with power to administer them, to manage the different enterprises and businesses of defendant (Benítez Rexach), without altering their system of management and with power to receive the civil fruits therefrom, in the same manner as an attorney-in-fact; c.—It is ordered that the said sequestrator receive all of the movable and immovable properties which are the subject of this sequestration, under an inventory prepared in the presence of a Notary Public . . . ; d.—The Sequestrator already designated is authorized during his administration to draw against the accounts in the name of the defendant (Bank accounts)—for the payment of the wages of workers, employees, laborers, etc. and for his own fees, as well as for the purpose of paying the expenses of maintaining (said properties) with the obligation of rendering an accounting on the occasion of termination of the sequestration; e—(. . .); f—(. . .); g—To order the provisional execution of this order without bond, notwithstanding any appeal against the same."

Four or five months thereafter Antonio Casals Piñeyro was indicted and sentenced for robbery and a Mr. Richard-

son was appointed and took over as sequestrator. The seizure was made suddenly by soldiers who took over everything including taxpayer's office and records and papers and he had to leave and thereafter had no access to his office, his residence was searched and he was able to save only a few of his papers. The Captain and crew of his dredge and Masters of his ships were ousted, the log of his dredge, of United States registry, was taken and the United States flag flown by it was taken down. Taxpayer thought no inventory was made at the time of seizure but subsequently one was made. The Dominican Dictator Trujillo had been assassinated in May 1961, and at the time, following a Coup de etat the "Consejo de Estado" took over the Dominican Government, under which one Mario Penso Fondeur was appointed Secretary of Public Works, who instituted a suit against taxpayer on behalf of the Dominican Government to recover $9,000,000.00 in damages allegedly due because the harbor constructed by taxpayer at the Port of Santo Domingo was useless and had caused the destruction of Tourism, and it was in this suit that seizure and sequestration was ordered.

On July 6, 1962, following the nullification of taxpayer's denaturalization, he filed a federal amended tax return for 1958 (embracing the entire year) and federal income tax returns for the years 1959, 1960 and 1961, with letters attached to each explaining the reasons for delay in filing and stating:

> "You will note from the letter of Montoya & Muñoz Veloso that due to the seizure by the present Dominican Government of all of the Dominican properties of Mr. Benítez Rexach, including his office and papers and records, these returns have been prepared as best they could be from data at hand which is not adequate. Mr. Benítez Rexach and his accountant have done the best they could do under the circumstances.
>
> "Efforts are being made by Mr. Benítez Rexach for recovery of his properties, but due to the chaos and

anarchy that prevails in the Dominican Republic it may be sometime before he is successful. If and when he recovers his records and papers he may submit amendments to these returns."

December 18, 1963 a jeopardy assessment was made against taxpayer for an income tax deficiency plus interest and fraud penalties for the year 1959 in the total amount of $662,052.62, and a jeopardy assessment for an income tax deficiency, interest and fraud penalty for the year 1961 in the total amount of $2,272,042.95.

The present action was brought February 10, 1964 to foreclose liens on said Puerto Rican properties of taxpayer and his wife, Lucienne D'Hotelle de Benítez Rexach and recover the amount of said assessments for the years 1959 and 1961. The income on which the assessments were made except for a constructive dividend paid to taxpayer by Escambrón Development Company and except for an item of interest paid on his wife's bank account in New York, was income determined by the Commissioner as profits derived during said years by taxpayer from construction contracts with the Dominican Government part of the performance of which took place (except for the contract and supplemental contract for the construction of the Harbor and Harbor Facilities at the Port of Boca Chica hereinafter to be mentioned), and on which the Commissioner determined the profits to be 57½% of that portion of the contract prices allocated to said years instead of 1/11 of the contract prices determined by him and accepted and held to be valid by this Court in the previous cases, and used by taxpayer in his 1959 and 1961 returns except with respect to the Yuna-Barracote contract hereinafter to be mentioned. And again the assessment was made on the total of the profits without regard to the non-taxable one-half vested interest of taxpayer's wife, a non-resident alien, and contrary to the holding of this Court in the previous cases.

Following filing by the taxpayer of his answer in the present case in which among others, the defenses of res

judicata and estoppel were set up, plaintiff filed an amended complaint praying among other things that the judgments in the previous cases be set aside, and that plaintiff be relieved of its stipulations in the previous cases on the ground of fraud and deception of taxpayer alleged to consist in the following acts and things:

"1. That Mr. Benítez had falsely stated under oath that his wife lost her United States citizenship prior to 1949 and acquired Dominican citizenship, and that he and his said wife changed their matrimonial residence and domicile from Puerto Rico to the Dominican Republic in 1944.

"2. That he had fraudulently failed to disclose three certain contracts made in 1951 and 1952.

"3. That he had fraudulently failed to disclose that he had paid to Rafael L. Trujillo Molina, then an official of the Dominican Republic, sums in the approximate amount of one-third of the face amounts of the contracts with said government, which payments were not proper and allowable deductions as business expenses.

"4. That he had fraudulently denied that he had records which could be used to reconstruct his costs and income from contracts with the Dominican Republic during the years 1951 through 1958.

"5. That in answer to interrogatories he had fraudulently stated that he had used and expended vast quantities of material and labor in the performance of said contracts which in fact he had not used or expended.

"6. That he had conspired with Rafael L. Trujillo to obtain foreign tax credits by getting payments from the Dominican Government not in fact due, returning such payments to that government for

taxes and using the receipts therefor to reduce his United States liability."

Following the taking by plaintiff of the deposition of former officials of the Dominican Government in which the testimony and official documents disclosed that plaintiff had paid his Dominican taxes and had not committed the acts described in paragraph 6 above, plaintiff withdrew the said amended complaint and on March 23, 1965 filed a new and separate action in this Court to set aside the judgments in the previous cases, and relieve plaintiff of its stipulations because of fraud and deception of taxpayer alleged to consist only of the acts and things set out in numbered paragraphs 2, 4 and 5 above and at the trial of this new case plaintiff abandoned its allegations of the acts and things set out in paragraphs 4 and 5 above. The Court found that there had been no fraud or deception of taxpayer and entered judgment dismissing the action. (*United States* v. *Rexach,* 41 F.R.D. 180).

The deficiency assessments for the year 1959 is made up as follows:

(a) Income derived from a contract with the Dominican Government, designated as Contract No. 182 (Customs House Building) in the amount of $700,000.00 executed July 24, 1958, and published in the official Gaceta No. 8278. Work on this contract was to commence August 1, 1958 and it was to be completed within 15 months. The monthly gross receipts from this contract were computed to be $46,666.66 per month (i.e. $700,000.00 ÷ 15 months), and work was to be in progress on this contract during ten months of 1959. The Commissioner determined that the gross receipts from this contract to be allocated to the year 1959 were $466,666.70 (i.e. 10 months × $46,666.66 per month). Taxpayer in his 1959 return reported this contract with gross income also of $466,666.70 and computed his net profit as 1/11 of the gross of $466,666.70 according to

the determination in the previous cases, whereas the Commissioner assessed and maintained that taxpayer's net profits on this contract should be computed as being 57½% of said gross of $466,666.70. The gross amount of the contract price allocable to the year 1958 was 5 months × $46,666.66, that is, $233,333.35 and in his 1958 amended federal return taxpayer reported 1/11 of this amount as his net profit for 1958 derived from this contract. No deficiency had been assessed against him on his amended return for 1958.

(b) Income derived from a contract with the Dominican Government designated as Contract No. 90 (Construction of the Port of Azúa) in the amount of $4,750,000.00, executed April 19, 1956, published in the official Gaceta No. 7978. Work on this contract was to commence on May 1, 1956 and was to be completed within 35 months. The amount of monthly gross receipts allocated to this contract was $137,714.29 and work on this contract was taken to be 3 months of 1959. Thus gross receipts from this contract allocable to 1959 were therefore $407,142.72. In his 1959 return taxpayer reported 1/11 of this gross amount as net profits as in the previous cases, but the Commissioner computed his profits as 57½% of said gross amount. The profits from the 8 months of work on this contract in 1956 and the 12 months work on this contract in 1957 were computed and held by this Court in the previous cases to be 1/11 of the gross amount allocable to these years, and in his amended return for 1958 and his return for 1957, plaintiff reported profits of 1/11 of the allocable gross amount. There was no deficiency assessment on the amended return for 1958.

(c) Income derived from a contract with the Dominican Government known as Contract No. 182 in the amount of $200,000.00, executed July 24, 1958, published in the official Gaceta No. 8278. Work was to begin on this contract August 1, 1958 and be completed

within 4 months. A profit of 1/11 on the price of this contract was reported by taxpayer in his amended return for 1958, and no deficiency assessment was made with respect thereto. By written stipulation plaintiff concedes that profits on this contract were erroneously included in the 1959 deficiency assessment.

(d) Payments of $33,927.22 from Escambrón Development Company to taxpayer which the Commissioner determined to be constructive dividends made to taxpayer and which taxpayer claims to be a payment on account of the indebtedness due by the said corporation to the marital community of taxpayer, and his wife Lucienne D'Hotelle de Benítez Rexach, deceased.

(e) The amount of $216.00 as liability for self-employment tax.

(f) Normal deductions were allowed and made by the Commissioner including the amount of $50,000.00 as a reasonable exempt earned income tax allowance under Section 911 of the Internal Revenue Code of 1954.

(g) Plaintiff conceded by written stipulation that it was error to tax all of said income of taxpayer and that plaintiff is bound by the judgments of this Court in previous cases holding that a one-half vested interest in income derived from said construction contracts belonged to his said wife, a non-resident alien, and which is not taxable by the United States.

(h) A penalty for fraud was asserted and imposed by the Commissioner of 50% of the tax computed by him under Section 6653(b) of the Internal Revenue Code. Taxpayer claims that the penalty was unlawfully assessed.

The said deficiency assessment for the year 1961 was made up as follows:

(a) Income derived from a contract with the Dominican Government designated as Contract No. 33 (Yuna

Contract), executed April 9, 1961 for the price of $4,700,000.00 and published in the official Gaceta No. 8576. Taxpayer was paid $200,000.00 on account of this contract in 1961, and it was suspended by order of the Dominican Government in June 1961. Taxpayer is presently controverting with the Dominican Government the right to suspend said contract and the right of taxpayer to damages. The Commissioner determined that the profits from this contract were 57½% of $200,000.00. In his return for 1961 taxpayer showed and claimed a loss on this contract of not less than $208,934.72 which the Commissioner in his assessment disallowed.

(b) Payment made to taxpayer by the Dominican Government of $1,552,000.00 in settlement of his claim for compensation for dredging of rock during the performance of the contract and supplement thereto for construction of the harbor works at the Port of Boca Chica under Contract dated August 3, 1955 approved by Congressional Resolution No. 4300 and published in the official Gaceta No. 7901, for the total amount of $3,500,000.00, the items of work to be performed thereunder being as folows:

(1) Construction of 2,000 linear feet of wharves	$2,000,000.00
(2) Construction of 10 steel guards	100,000.00
(3) Dredging entrance channel of the harbor to a minimum depth of 32 feet representing a total of approximately 2,000,000 cubic yards	1,200,000.00
(4) Construction of roadway 2,000 feet long with a curb and culvert of reinforced concrete and surfaced with asphalt concrete	200,000.00
Total:	$3,500,000.00

By the supplemental contract of July 2, 1956 in the amount of $380,000.00 construction of a warehouse with reinforced concrete wall, steel frame, aluminum roof and side covering, and a concrete floor was added. The contracts were performed during the years 1955 through 1958 and the total price of $3,880,000.00 was paid during said years. Contrary to the silt, sand and other soft material normally encountered and to be expected in the area, rock was encountered during the dredging. The presence of the rock was reported to the Dictator Trujillo and was shown to him at the work site and he ordered taxpayer to proceed and assured him he would be compensated. A million cubic yards of the two million cubic yards dredged consisted of rock. The going price in the Dominican Republic for dredging rock was $4.00 per cubic yard and the taxpayer made a claim for extra compensation. In April 1958, a month after the previous action covering the years 1951 to 1956 was brought, taxpayer testified in a deposition taken by plaintiff that he had sustained a loss of over $1,000,000.00 in the Boca Chica contracts, that they had not been completed nor liquidated, but the Commissioner in the two previous cases covering the years 1951 to 1956 and 1957 to 1958 (up to July 14) treated the contracts as completed and liquidated and determined that profits derived from the contracts were 1/11 of the contract price of $3,880,000.00 and assessed a tax thereon which method as stated was accepted by taxpayer for the years involved. Taxpayer testified that with the settlement of his claim for dredging rock, he sustained a loss of over $1,000,000. The Commissioner determined that the entire payment of $1,552,000.00 in 1961 settlement of taxpayer's claim represented profits derived from said contract. In his 1961 return taxpayer did not report said payment of $1,552,000.00 as income.

(c) The expenses shown and claimed on his 1961 return in his operations for 1961 of $407,934.72 were dis-

allowed by the Commissioner in his assessment as a result of which the losses shown and claimed in said return on the Yuna Contract were disallowed.

(d) Interest derived from bank accounts in The First National City Bank of New York of his said wife in the amount of $8,672.56. The parties have stipulated that taxpayer has a vested one-half interest in said interest and that $4,313.78 properly forms a part of his income for 1961.

(e) The amount of $216.00 as liability for self-employment tax.

(f) Normal deductions were allowed and made by the Commissioner including the amount of $25,000.00 as a reasonable exempt earned income allowance under Section 911 of the Internal Revenue Code.

(g) Fraud penalties were asserted and assessed under Section 6653(b) of the Internal Revenue Code of 1954, amounting to $709,794.65. Taxpayer claims the assessment of these penalties was unlawful.

(h) Plaintiff admits that it is bound by the judgments in the previous cases covering the years 1951 to 1956, both inclusive, and the years 1957 and 1958 (up to July 14), and that it was error on its part to assess taxes on the one-half vested interest of taxpayer's wife in any income derived from the said contracts with the Dominican Government.

The Dominican Republic for some 30 years prior to his assassination in May 1961 was ruled by the absolute Dictator Trujillo. There were no limits to the power he exercised, he was the government, he commanded everything, and could order extra work under government contracts. He and his family had an interest in every kind of business or enterprise in the country. (*United States* v. *Rexach,* 41 F.R.D. 180, footnote 1).

Taxpayer at the request or direction of the Dictator prepared plans and specifications, including the necessary

engineering of harbor works projects which the Dictator wanted, drew up contracts for construction of the projects, and got the contracts but in order to obtain the contracts taxpayer had to pay or obligate himself to pay to the Dictator one-third of the total contract price, and this was the practice followed until the Yuna Contract was awarded in public bidding to taxpayer as the lowest bidder. Plaintiff admitted that these payments to the Dictator were ordinary business expenses in the Dominican Republic and were properly deductible from gross income as such under the Federal Internal Revenue Code until the effective date of the Technical Amendments Act of 1958 (26 USC 162, Trade or Business Expenses), Sections 5(b) and (c) of which read as follows:

> "(b) The amendment by subsection (a) to subsections (c) and (d) of this section shall apply only with respect to expenses paid and incurred after the date of enactment of this Act (September 2, 1958). The determination as to whether any expense paid or incurred on or before the date of the enactment of this Act (September 2, 1958) shall be allowed as a deduction, shall be made as if this section had not been enacted and without inference drawn from the fact that this section is not made applicable with respect to expenses paid or incurred on or before the date of the enactment of this Act (September 2, 1958)."
>
> "(c) Improper payments to officials or employees of a foreign government.—No deduction shall be allowed under subsection (a) for any expenses paid or incurred if the payment thereof is made, directly or indirectly, to an official or employee of a foreign country, and if the making of the payment would be unlawful under the laws of the United States if such laws were applicable to such payment and to such official or employee." (Pub. Law 85-866).

The obligation of taxpayer to pay to the Dictator one-third of the contract prices of the contract for construction of

the Customs House Building and the contract for the construction of the Port of Azúa, described hereinabove, was incurred by taxpayer at the times he obtained the contracts, which in each case was prior to the effective date of Section 5(b) of the said Technical Amendments Act of 1958. At those times Dictator Trujillo was not an official of the Dominican Government, and not an employee of it; he was the Government. Taxpayer did not pay to the Dictator any part of the $1,552,000.00 paid to him in 1961 in settlement of his claim for rock dredging under the Boca Chica contract. A few days after the payment the Dictator was assassinated.

With the advent of the first of the previous suits against taxpayer in this Court, the Dictator was concerned that this practice we have described would become public knowledge. Agents of plaintiff were prohibited from inspection of taxpayer's papers and records in the Dominican Republic and the projects taxpayer had constructed or was constructing, although taxpayer had consented to such examination provided that the Dominican Government would permit it. It was the coercion of the Dictator that resulted in his denaturalization July 14, 1958, and only after the Dictator's assassination did taxpayer institute proceedings in which his denaturalization was held to be null and void ab initio.

Taxpayer performed other services for the Dictator and his government. He served as counsel to the Dictator's Army and Navy and as Commercial Attaché in France, and he did other jobs for the Dictator using his machinery and equipment and his ships to transport material. And taxpayer's aeroplane was kept in France available for use and used by the Dominican Diplomatic Mission in France (of which his wife was a member as Cultural Attaché) and available for use and used by the Dominican officials. Taxpayer testified that

> "Naturally when they needed a service from me they asked me and consequently as a question of good rela-

tions under the system under which I work I also tendered the services whether it was equipment or my personal services in any way whatsoever that the Government might need."

After the Azúa Contract taxpayer obtained no contracts other than that for construction of the Customs House for $700,000.00 and Contract No. 182 for $200,000.00, neither of which required any substantial use of his dredge and floating equipment until he obtained the Yuna Contract on public bidding in 1961. Some of the Trujillo family had formed a company called "Cocimar", acquired a dredge and established a drydock, and had obtained the important harbor construction contracts during that required. Taxpayer was not permitted to take his dredge and auxiliaries out of the Dominican Republic.

In his determination that taxpayer's profits on the payments received in 1959 on the Customs House Contract and on the Azúa Contract (see pars. (a) and (b), pp. 8 and 9 above) amounted to 57½% of said payments, the Commissioner, assuming that taxpayer paid to Trujillo 33⅓% of those payments, held that such payments were not deductible as business expenses, under Section 5(c) of the Technical Amendments Act of 1958, and treated this 33⅓% as if they constituted profits to taxpayer. In doing so the Commissioner erroneously applied the said law because the obligation of taxpayer to make payments to the Dictator were incurred prior to the effective date of that Act. Nor was any evidence presented as to whether these payments were made prior to or after the effective date of said Act. Moreover, the Dictator was not an official of the Dominican Government, and certainly not an employee during the years 1959 and 1961; he was the Dominican Government. And in determining that profits on the Yuna Contract payment of $200,000.00 to taxpayer in 1961 were 57½% he assumed that 33⅓% of that amount was paid to the Dictator and disallowed that amount, although taxpayer did not have to pay or obligate himself to pay the Dictator 33⅓

of the price of said contract, and in his return for 1961 in which he listed his costs and expenses in the performance of the Yuna Contract until suspended, he does not include as an expense or cost any amount paid to the Dictator.

Aa to the remaining 24⅛% of the 57½%, the only evidence presented by plaintiff was the written report of Mr. H. K. Armstrong, a hydraulic engineer, and Construction Management Engineer, Department of the Army, Office of Chief of Engineers, admitted in evidence under a stipulation that if present as a witness he would testify as to the contents of said written report. He was in the Dominican Republic about three and a half weeks during the last part of April and the first of May 1965, at which time Mr. Richardson was in possession of taxpayer's properties as sequestrator. He made inspection visits to the jobs at Boca Chica, Azúa, Haina and Santo Domingo, but not to the Customs House nor the Yuna contract. The only part of his conclusions as to estimated costs to the taxpayer which could possibly relate to the construction of the Customs House, the harbor at Azúa and the work on the Yuna Contract are paragraphs 20 and 21 of his report reading as follows:

> "20. To develop a clear and concise presentation of the cost of work performed by Rexach for the Dominican Government is like unravelling a snarled and knotty ball of yarn. No particular pattern can be followed and information unearthed from here and there must be appraised for its value and used in a variety of methods of computation. As indicated herein, however, reliable cost estimates can be developed. In view of present knowledge of what to expect and with the experience of knowing where to look for source data, the task is not so difficult as it appeared at the onset. The conclusion is that revised estimates will support the fact that the aggregate cost of all work will not exceed 40 to 45 percent of the contract payments.

"21. Gross contract payments for work performed by Rexach for the Dominican Government during the period 1951 to 1958 total approximately 37 million dollars. A cost estimate for this work will range from 15 to 17 million dollars. It is estimated that the preparation of refined estimates covering this work, including investigations, engineering quantity computations, drafting, reproduction work, and the preparation of exhibits for court presentation will cost in the range of $10,000 to $15,000, exclusive of costs incurred for salary and expenses by the author and by a representative of the Internal Revenue Service in full time collaboration with the author. It is estimated that approximately six months would be required to obtain data, perform computations and to prepare exhibits for use in court."

Although there are no figures in his report as to costs of the work to taxpayer on these contracts, description of the projects, nor materials and supplies used, it is clear that Mr. Armstrong did not take into consideration the payments of 33⅓% of the contract prices to the Dictator (other than in the case of the Yuna Contract). Correcting his estimates that he thought would be shown by an appraisal, his tentative conclusions would be that on the whole the costs to taxpayer of the works constructed by him would be 73⅓ to 78⅓ percent of the total contract price. This is not an estimate of costs but rather what Mr. Armstrong thought such an estimate, if made by him, would show.

Mr. Armstrong's report also states that it was based

"on information and knowledge obtained as a result of investigations conducted in the Dominican Republic including

"(1) Interviews with

(a) workmen,

(b) work supervisors,

(c) Material vendors,

(d) local engineers and contractors

all of whom have some knowledge concerning the work.

"(2) Inspection visits to the jobs at Boca Chica, Azúa, Haina and Santo Domingo.

(3) Some limited physical examinations were made.

(4) Scope of work was observed.

(5) Quality of work and workmanship were observed."

He does not give the names of the persons whom he interviewed, the knowledge concerning the work that they had, what was done by him on the inspection visits to Azúa, what were the limits of the physical examinations, nor the scope of the work observed. His report is not adequate or sufficient to show what the costs to taxpayer of said projects were and the Court cannot find from it that the costs of the work of these projects (Customs House, Azúa and work on Yuna) were from 73⅓ to 78⅓ percent of the contract prices. Mr. Armstrong's report on Boca Chica, hereinafter to be mentioned, shows higher estimated costs. As to Yuna the evidence shows actual costs incurred by taxpayer.

Taxpayer, after his experience as to records of costs and payments under Dominican contracts instructed his bookkeeper to keep a complete record of the costs incurred in the work under the Yuna Contract, and from a check voucher journal, it appears that these costs were not less than $408,934.72 not including depreciation, and engineering, which less the $200,000.00 payment on account of the contract price, resulted in a loss of $208,934.72. At the time of the suspension of this contract, taxpayer had dredged 1,133,000 cubic yards of material as shown in the log book of the dredge, and the Dominican Department of

Public Works figures that $800,000.00 was due taxpayer for the work done. This amount is substantially less than taxpayer's claim, but since 1961, he has been unable to get any payment from the Dominican Government in spite of his efforts. At taxpayer's estimated cost of 40¢ per cubic yard for dredging, total costs of dredging would be $453,200.00 which with $50,000.00 shown to have been paid for materials and spare parts purchased in continental United States, would increase total costs to $503,200.00. This figure does not include depreciation, supplies, spares and materials used which were on hand at the time he commenced work, nor engineering costs nor those of marshalling his equipment at the work site, some 200 miles distant from Santo Domingo. To marshal his equipment at the work site the dredge had to be prepared to make it seaworthy by boarding it up with steel plates and towed some 200 miles to Samaná Bay during which trip it had to be held up for several days at Catalina Island (about 100 miles from Santo Domingo) waiting for favorable weather before crossing to Samaná Bay. The work area was isolated and fuel, supplies, food and water had to be transported there; floating equipment such as tugs, lighters, floating derricks, bulldozers and other equipment had to be marshalled at the work site; insurance on the dredge had to be purchased; and logs from the mouth of the Yuna River had to be cleared out and other work done preliminary to beginning of dredging. To house his workmen taxpayer built a floating hotel the construction of which cost $90,000.00. Taxpayer estimated that he had incurred in costs amounting to some $1,000,000.00 with respect to the Yuna Contract.

Plaintiff produce no evidence that profits from the Yuna Contract were 57½% of the $200,000.00 payment received on account of the contract in 1961. And taxpayer never agreed or stipulated that the method used by the Commissioner to determine profits from Dominican contracts employed by him in previous years could be valid in 1961. Such a method would manifestly be unreasonable and not

calculated to show net income of taxpayer. Since the amount of the minimum actual costs incurred by taxpayer in performing the Yuna Contract, and the amount received as payment on account of the contract price in 1961 are known, and since the contract was begun and suspended in that year, there is no need to use any formula for determination of profits or loss. The actual work performed under that contract is such as to compel the conclusion that the costs thereof substantially exceeded $200,000.00, and the assessment by the Commissioner of a profit of 57½% of the $200,000.00 was arbitrary and without any reasonable basis since the minimum costs figures and amount received on account were shown in taxpayer's 1961 return. It does not appear that the Commissioner or his agents made any investigation or discussed the matter with taxpayer prior to making the said assessment. It is highly doubtful, moreover, that a profit of 57½% of the contract price is ever earned on such a contract as the taxpayer testified.

It is elementary that in a suit to collect taxes the Government occupies the status of a private litigant and the burden of proof is upon it. It is true that a prima facie case is established by proof that the tax liability has been assessed and that the taxpayer defendant must go forward to sustain his defense. This burden to go forward is procedural and is met if the taxpayer produces competent and relevant evidence from which can be found that he did not receive the income alleged in the deficiency. When this burden to go forward is met, the burden of proof shifts back to the Commissioner to prove the existence and amount of the deficiency. (*Foster* v. *Commissioner,* 391 F. 2d 727, 735). And the determination of the Commissioner is not evidence to be weighed against that produced by the taxpayer. (*Lawrence* v. *Commissioner,* 143 F. 2d 456). As to fraud the Government has the burden of proof at all stages of the proceedings (26 USC 7454). As to the assessment of 57½% of the contract prices allocated to or received in the

years 1959 and 1961 from the Customs House, Azúa and Yuna Contracts, taxpayer met the burden of going forward, and the Commissioner has failed to sustain the burden of proof as to the existence and amount of these items of the deficiency. On the contrary the deficiency is based on a mistake of law (see *9 Law of Federal Income Taxation, Mertens,* Sec. 50.65, p. 187) and the report of Mr. Armstrong as to what an estimate of costs when made might show. There have been no changes in the circumstances and applicable law since 1951 to justify the Commissioner in determining profits on the Customs House and Azúa Contracts to be 57½% of the allocable contrict prices instead of 1/11 of such contract prices as previously made by him, and in doing so the Commissioner has not been consistent. We think the Commissioner is equitably estopped from making this change, (see *10 Law of Federal Income Taxation, Mertens,* Sec. 60.21, p. 96; *Thomas* v. *C.I.R.,* 324 F. 2d 798; *Tait* v. *Western Maryland RR Co.,* 289 U.S. 620, 53 S.Ct. 706, 707, 77 L. ed. 1405), and that the doctrine of quasi estoppel also precludes him from making such a change (*10 Law of Federal Income Taxation, Mertens,* Sec. 6.04, pp. 14-15; *Orange Securities Corp.* v. *Comm.,* 131 F. 2d 662).

It follows from what we have said that the disallowance of the loss of $208,934.72, reported in taxpayer's 1961 return, by the Commissioner in his said deficiency assessment was erroneous.

The funds previously advanced by taxpayer to Escambrón Development Company were treated by the Commissioner as capital contributions, no note or notes having been given by the corporation therefor, and no interest having been charged therefor, and taxpayer and his said wife owned all of the outstanding stock of the corporation. The corporation's records were examined by Mr. Lyden, and depreciation claimed by the company was reduced to conform to Internal Revenue Service depreciation guidelines set forth in Bulletin F, which reduction resulted in sufficient

earnings and profits so as to constitute the $33,927.22 payment made to the taxpayer in 1959 taxable dividends. The corporation owned and operated a hotel in Puerto Rico and its income was not subject to Federal Income Tax, and the rates of depreciation which it used were rates customarily used in Puerto Rico for hotels. Its income tax returns had been inspected by the Commonwealth Government and no objection to the said rates had been made. In a previous inspection by a Federal Internal Revenue Agent no objection was made to the use of said rates, nor to payments on account of the indebtedness to taxpayer.

As stated by plaintiff in its brief

> "In determining the taxable status of a distribution received from a foreign corporation, the latter's earnings or profits are to be ascertained in accordance with the same principles applicable to a domestic corporation without regard to standards prescribed by a foreign law for computing income or earnings or profits." *1 Merten's, Law of Federal Income Taxation,* Section 9.37.

From the application of this principal it follows that the payments of $33,927.22 by Escambrón Development Company to taxpayer in 1959 constituted constructive dividends, and this total amount was correctly assessed against taxpayer as income, since under Puerto Rican law the wife does not have a vested interest in income received by her husband.

As to the amounts allowed by the Commissioner as reasonable exempt earned income tax allowances ($50,000.00 in the assessment for 1959 and $25,000.00 in the assessment for 1961) under Section 911 of the Internal Revenue Code of 1954, taxpayer failed to present any evidence or to cite any provision of law that would overcome the presumption of the correctness as to the amount of these allowances and the Court holds them to be correct. Nor did taxpayer present any evidence or cite any provision of law that

would destroy the presumption of correctness of the assessment of $216.00 as liability for self-employment tax in each of the years 1959 and 1961.

As conceded by plaintiff the inclusion in the deficiency assessment for 1959 of profits on Contract No. 182 executed July 24, 1958 and published in the official Gaceta No. 8278, was erroneous; and as conceded by plaintiff the assessment of the tax against taxpayer on the total amount of the income was erroneous, and the one-half vested interest of his wife in the Dominican income must be excluded. And as agreed to and stipulated by the parties, only one-half of the interest on his wife's bank account with The First National City Bank, amounting to $4,313.78 may be included in the 1961 assessment, and the other half amounting to $4,313.78 erroneously included by the Commissioner must be excluded.

Taxpayer sustained substantial loses in the performance of the contract and supplement thereto for construction of the harbor and facilities of the Port of Boca Chica and the payment he received in 1961 from the Dominican Government in settlement of his claim for dredging rock was not sufficient to cover his said losses. Although taxpayer had informed plaintiff that he had sustained losses of over a million dollars and that the contract had not been liquidated (i.e. paid in full) plaintiff nevertheless treated it as completed and paid for and insisted on the application of the formula used by him in the assessments for the years 1961 to 1956, both inclusive, and the years 1957 and 1958 (up to July 14) for determining net profits on the contract price, to which taxpayer agreed by stipulation which provided that such formula was to be applied to those years only. The showing of his losses was not therefore relevant at that time. Moreover, taxpayer could not show those losses at that time without the risk of confiscation of his Dominican properties and probably risk of bodily harm, since it would have involved revealing the payments of 33⅓% of the contract price to Dictator Trujillo. Taxpayer had some

84 men working at Boca Chica with the dredging of the rock and his dredge was in operation there some two years instead of six months an anticipated. The cost of operation of the dredge not including parts and repairs and depreciation was $180,000 to $200,000 per month. Due to time consumed in making repairs it was engaged in actual dredging 15 to 20 days per month and at times daily production was not more than 100 cubic yards. After the job was completed the dredge had to be put in drydock, there were cracks in its bottom and a new main pump had to be installed. Some 12 spuds were broken each of which cost $25,000, and 5 or 6 manganese cutter shafts were used, each costing $7,000.00. During the work at Boca Chica taxpayer's dredge was damaged by sabotage in the amount of $50,000.00.

Upon completion of the project the work was inspected by the Dominican Government and accepted and he was paid for dredging 2,000,000 cubic yards of material, although taxpayer said he dredged more than that, and the Dominican Department of Public Works found that of the 2,000,000 cubic yards dredged, 1,000,000 cubic yards of the material was rock.

In paragraph 10 of his report on the estimated cost to taxpayer of the Boca Chica project Mr. Armstrong states:

> "10. Dredging operations at Boca Chica turned out to more difficult than the expectations of the contractor. The material was not sand and silt as normally encountered when dredging sedimentary deposits in river channels and in harbor areas. Materials were sand and coral rock formations, the latter of varying degrees of density and hardness. Answer to Question No. 176 reports, 75 percent solid rock and the remaining 25 percent sand. Solid rock requires drilling and blasting to loosen it before it can be handled by a cutter head dredge. No drilling and blasting were done in connection with the dredging at Boca Chica. It is acknowledged that material was difficult to loosen with the

cutter. As large chunks of coral formations were broken free by the cutter action and drawn into the pump, clogging of the pump impeller resulted, requiring numerous shut-downs for the purpose of rock removal and cleaning of the pump. Due to the hard and firm texture of the material in place, and to the difficulty in loosening the material with the cutter, plant production was considerably below normal expectations."

And he also said that the dredging operations were three times more difficult because of the rock. In that report, however, Mr. Armstrong assumes, (subject to verification, as he says) that only 1,650,000 cubic yards of material was dredged, and he assumes (subject to verification, as he says) that the dredge was in operation there only 668 days instead of 730 days (i.e. two years), and it does not appear from his report that he knew the quantity of rock that was dredged. Mr. Armstrong was not present, of course, at the time of the dredging operations, and he did not interview the dredge Captain nor its Chief Engineer nor its Chief Welder, all of whom were in San Juan or the Dominican Republic at the time Mr. Armstrong was there, nor taxpayer.

Mr. Armstrong did not include in his costs the 33⅓% paid to the Dictator, and his unit labor costs shown in the report were based on lower salaries and wages than those paid by taxpayer. Other known expenses such as the Christmas-bonus tax were not included.

If Mr. Armstrong's report of estimated costs of dredging be adjusted by using the 2,000,000 cubic yards dredged instead of 1,650,000 cubic yards, of which 1,000,000 cubic yards was rock, by taking the actual time the dredge was in operation and by including as costs the 33⅓% paid to the Dictator, a loss of some $510,000.00 will be shown in the dredging. And if his report on the cost of the other work at

Boca Chica be adjusted by including as costs the 33⅓% paid to the Dictator, it would show a profit of $375,667.00 This would then result in an overall loss of some $134,333.00.

Yet in the other cases taxpayer accepted the Commissioner's method by which he determined, approximately $338,000.00 as profits, and was taxed on one-half that amount plus interest which he paid.

While the report of estimated costs by Mr. Armstrong on the Boca Chica project confirms the taxpayer's showing of a loss, it is not adequate to show actual costs. It is an opinion of what as estimate of costs by him would show if made.

The report includes nothing for costs of engineering and design of the project which was furnished by taxpayer, it fails to reveal the names and identity of the persons interviewed and their knowledge of the work, nor of the suppliers nor invoices consulted, and other details required for an evaluation of his opinion. It is not, and was not a final estimate of costs for the preparation of which substantial further study, tests and vertifications would be required.

Mr. Armstrong implied that dynamite should have been used to loosen the rock, suggesting that the cost of removal would have been less. Taxpayer stated the reasons why dynamite could not be used, including his statement that he would not touch a stock of dynamite in the Dominican Republic. The costs that are relevant are those incurred by taxpayer, not costs that another contracting engineer might have incurred in some other place.

Mr. Armstrong was not a contracting engineer and had performed no harbor works in the Dominican Republic. Taxpayer would be the most competent person to testify as to the costs of the Boca Chica project since he designed it, constructed it with his organization and equipment and paid

the costs, and is one of the leading harbor works engineers with some fifty years of experience of which twenty-seven relate to work in the Dominican Republic. He was an interested witness but the Court finds nothing in his extensive testimony as to the Boca Chica project which suggests that its probity is affected by the interest of the witness. It establishes that taxpayer sustained a substantial loss on the Boca Chica contract and that his costs in performing the contract and supplemental contract were substantially in excess of the contract prices including the $1,552,000.00 that he received in 1961 in settlement of his claim.

Profits from the contracts, which in fact he did not receive, were determined in the previous cases by the Commissioner on the theory that the contract had been completed and paid in full although taxpayer informed the plaintiff in April of 1958, immediately following the filing of the action embracing the years 1951 to 1956, both inclusive, that the contract had not been completed and liquidated and that he sustained a loss in its performance in excess of $1,000,000.00. At that time and at the time of the second action covering the years 1957 and 1958 (up to July 14) he had no alternative but to accept the Commissioner's method of determining profits. Under interrogations by attorney for plaintiff, taxpayer repeatedly testified in complete detail as to the performance of the contract and its supplement, and after the Dictator's assassination he testified as to the substantial cost of 33⅓% of the contract prices paid to the Dictator to obtain the contracts. Plaintiff called taxpayer as a witness for these interrogations, referring to him as a hostile witness. But the Court finds nothing in this testimony to indicate that his interest affected the truthfulness of his statements. He stated that he had nothing to hide, and made available to plaintiff and its agents all of his papers, records and his information as to the design and construction of the project. His testimony cannot be disregarded merely because he is an interested party. Moreover, the conditions he encountered in the work

that caused his loss are confirmed by the report of Mr. Armstrong and his opinion as to what a cost estimate would show when adjusted to the facts as to the quantity dredged (determined by the Dominican Department of Public Works), the admitted payment of 33⅓% of the contract prices to the Dictator and the actual time of operation of the dredge also shows a loss. This loss was increased by the tax on the profits previously determined by the Commissioner which in fact he did not earn.

It would be manifestly unjust and not in accordance with law, to now assess a federal income tax on any part of the said payment he received in 1961 as net income, and the Commissioner's assessment of this payment as profits and its inclusions in the 1961 deficiency is erroneous.

In December 1966, after the trial of this case before the late Judge Clemente Ruiz Nazario, those of his Dominican papers and records that were extant were returned to him. The $9,000,000 suit against taxpayer in which the properties had been attached was never tried, the Dominican Government having realized that it had no cause of action. And the sequestration was ended by Court order but no accounting was ever rendered by the Sequestrator, and no costs were awarded to taxpayer. While at the time of seizure the properties were in first class operating condition, upon their return they were damaged, in disrepair, some had been sold or otherwise disposed of and others abandoned and rendered useless. A series of photographs made at the time of return show the damaged condition of a number of the principal items. Taxpayer estimated that the damage and loss amounted to approximately $1,000,000.00 and that it would take about six months to put the dredge in repair. The Dominican Government has never paid taxpayer any damages for his loss nor put the properties in the condition they were at the time of seizure. Although during the sequestration the properties were used as if the Dominican Government owned them, taxpayer has never been paid or otherwise compensated for such use.

After seizure his records and papers were taken from his office (destroyed by fire) and put in one of his cottages near the graving dock where they were permitted to be examined by an agent of the Commissioner during the time Antonio Casals Piñeyro was the Sequestrator, and later they were put in a shed at the graving dock. Taxpayer does not know whether all of his papers and records were returned, although after their return he tried without success to find documents relating to the Yuna contract.

While losses to an individual United States citizen or resident alien sustained by reason of seizure by the Government of Cuba are deductible as capital losses over a period of years pursuant to 26 USC 165, that provision of law is not applicable to damages or loss resulting from seizure by the Dominican Republic. Only Congress can prescribe the deductions allowable and while the present law may be discriminatory, such discrimination does not affect the constitutional validity of the existing law.

The loss in 1962 of the floating hotel through dismantling and theft of the materials of which constructed and the equipment installed therein constitutes a loss in 1962 and deductible under 26 USC 165(a) and (e). While theft includes embezzlement seizure has been held not to be a loss by theft. (See *5 Law of Federal Income Taxation, Mertens,* Sec. 28.59, pp. 269, et seq.). Losses from shipwreck are also deductible (26 USC 165), but taxpayer failed to show the losses to the two tugs, barge and floating derrick that were sunk.

While the evidence does not show the amount of annual depreciation of taxpayer's Dominican properties used in his Dominican business it does show that annual depreciation on his graving dock and the major items of his floating equipment such as the dredge and ships to be $130,338.00 calculated in accordance with the guidelines of Bulletin F. His tax return for 1960 shows no income and the deficiency assessed thereon was $53.91 which was not contested but is

not sought to be recovered in this action. His return for 1961 does not show depreciation of said items for that year. His returns for 1962, 1963 likewise show no income and there was no income in 1964. Annual depreciation for those years 1960, 1962, 1963 establish losses for those years and annual depreciation on those items for 1961 increase his loss for that year. These resulting losses are operating losses and are not only deductible in the year in which incurred but may be carried back two years and deducted and carried forward five years and deducted from gross income as provided in 26 USC 172. They cannot, however, be used to offset the amount of self-employment tax due.

No judgment may be obtained from a Dominican court against the Dominican Government without its consent and any recovery on taxpayer's claims for suspension of the Yuna Contract and losses from the seizure that he may ultimately obtain will have to be obtained by diplomatic proceedings. Taxpayer thus far has been able to recover nothing although the United States Department of State has been assisting him in his efforts. Taxpayer testified also that the Dominican Government has no funds with which to pay his claims. No bond was posted by the Sequestrator and taxpayer has no effective remedy to obtain an accounting.

After the return of his properties taxpayer made available to plaintiff in the Dominican Republic all of his papers and records returned to him, and plaintiff's agents examined them during a day and a half in October and again December 6 and 7, 1967, but they did not take the time necessary to make a thorough examination. Some of the papers and records were selected at random by the agents, taken by them and brought to Puerto Rico, with taxpayer's consent, to be examined in detail. The agents were looking primarily for evidence of the receipt by taxpayer of unreported income in 1959 and 1961; they were not making an audit, could not and did not prepare a profit and loss state-

ment. Mr. Fontaine, one of the agents, testified that he was not looking for costs and expenses and that

> "If income is not reported on the income tax return, any expense attributable to that income cannot be deducted. At that time I was shown this gross income (not, sic) submitted on the return. Any expenses attributable to income not shown on a return is not deductible, sir."

and that

> "There was one schedule that I prepared originally showing expenses of the ships, but inasmuch as I wasn't sure that all of the income of the ship was reported, and the expense was directly allocated to that specific ship, I dropped it all."

The records did show gross income in 1959 and 1961 from work done at the graving dock on ships other than those of taxpayer and from freight collected for cargo carried for others on his ships "Rio Haina" and "Puerto Trujillo". Some minor costs and expenses of this work and the ships appeared in the records but no attempt was made to find all of the costs and expenses by said agents.

Taxpayer testified that he was not engaged in the business of carrier, and the ships were used in some instances to carry cargo in order to decrease the loss from maintenance of them and their crews during periods in which they otherwise would have been idle, and that he derived no net income from them. In one instance the evidence showed that the cost of operating the ship on voyages to Curacao were in excess of the freight recovered.

At the time of filing his federal returns for 1958 (amended), 1959, 1960 and 1961 his papers and records had been seized and he had no access to them which was stated in the letters attached to his returns, and so were all of his Dominican properties. It was said that taxpayer should

have filed amended returns, but before he got his properties, papers and records back in 1966 the jeopardy assessment for 1959 and 1961 had been made, and this action brought and tried before the late Judge Ruiz Nazario.

This evidence as to receipt of gross income in 1959 and 1961 shown by the papers and records taken by plaintiff was admitted under the stipulation of the parties submitting the case for decision, and was for the purpose of sustaining the Commissioners assertion and assessment of fraud penalties, and as counsel for plaintiff stated, for offsetting taxpayer's losses.

The Internal Revenue Code (26 USC 6653(b)) provides that if any part of any underpayment of income taxes is due to fraud there shall be added to the tax an amount equal to 50 percentum of the underpayment. Fraud as the term employed in the statute is used means an actual and intentional wrongdoing and the intent required is one of a specified purpose to evade a tax believed to be owing (*Cevalu* v. *C.I.R.*, 276 F. 2d 122); and the burden of proving fraud is and remains on the plaintiff throughout the proceedings, and there can of course be no penalty of fraud without a tax deficiency (*10 Law of Federal Income Taxation, Mertens,* Sec. 55.10, p. 47). Since only net income is taxable, the showing of unreported gross income has been held to be insufficient to sustain the fraud penalty without evidence that taxpayer realized gain from such gross income. The fraud penalties asserted by the Commissioner in his assessment for 1959 and 1961 was not bottomed on the unreported gross income shown by that portion of taxpayer's papers and records taken by plaintiff's agents.

As to the constructive dividend which we have held to have been received in 1959, there was no intention of the taxpayer to evade a tax believed to be owing. There was no constructive dividend under Puerto Rican practice and law, public accountants retained by plaintiff were of the

opinion that there was no constructive dividends, and previous payments of the same kind had been made to taxpayer without objection from the Commissioner even after audit of the records and accounts by the Commissioner's agents.

Nor does the evidence show that plaintiff had any notice or information at the time of making his 1961 return that his wife had received or been given credit for the interest on her Bank account. Although taxpayer stipulated that he had a one-half vested interest in said interest, it is questionable that he did have such share under the law of New York where the marital community institution does not prevail, the state in which the interest was earned.

Plaintiff has not met the burden of proof required, and the assertion and assessment of the fraud penalties for 1959 and 1961 were and are contrary to the statute and cannot be included in the deficiency.

As stipulated by the parties and as heretofore held by this Court, taxpayer will be entitled to a tax credit against any Gross Receipts Tax paid under Dominican law on the income from his Dominican operations as provided by the Internal Revenue Code.

The parties are directed to draft and submit proposed findings of fact and conclusions of law, including computations of any amount of taxes held to be properly assessed under the deficiencies assessed for 1959 and 1961 under the holdings of this opinion, for approval by the Court, and the parties are granted a term of thirty days therefor from the date of this opinion.

San Juan, Puerto Rico, this 26th day of March, 1971.

/s/

Chief Judge, U.S. District Court

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 72-1051

UNITED STATES OF AMERICA
Plaintiff, Appellant,

v.

FELIX BENITEZ REXACH, ET AL.,
Defendants, Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF PUERTO RICO

Befort COFFIN, *Chief Judge,* McENTEE and CAMPBELL, *Circuit Judges.*

John J. McCarty, Attorney, Tax Division, Department of Justice, with whom *Scott P. Crampton,* Assistant Attorney General, *Julio Morales Sanchez,* United States Attorney, *Meyer Rothwacks,* and *Jerome H. Fridkin,* Attorneys, Tax Division, Department of Justice, were on brief, for appellent.

Walter L. Newsom, Jr., with whom *Rene Benitez* was on brief, for appelles.

June 27, 1973

COFFIN, *Chief Judge.* This is an appeal from a district court judgment upholding, except as to a pittance, a taxpayer's defenses against the United States in a substantial suit for taxes and fraud penalties. The background is picaresque, involving a colorful engineer-enterpreneur (taxpayer)[1] whose alleged tax liabilities stemmed from his

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[1] This suit was brought against both the engineer and his wife. Pursuant to a prior decision of the district court, *United States* v. *Rexach,* 185 F. Supp. 465 (D. P.R. 1960), the wife had a vested interest in one-half of his income as provided in Dominican law, and

long-enjoyed preferment, by grace of the late dictator of the Dominican Republic (Trujillo), as chief harbor developer of that country. Some of the alleged earnings from various harbor projects for the years 1959 and 1961 were sought to be taxed. Understandably, the records of complex, now receding events in a land where the old order has long ago yielded to a newer one were less than satisfactory. The trial, only the most recent chapter in a decade and a half of litigation, was an anomalous contest between the national government, armed chiefly with scraps of data and surmises, and the aging taxpayer, drawing primarily on his memory. The latter was held to be sufficient to withstand the attack. We reverse and, with much dislike for prolonging the perdurable, remand.

The precise issues all involve, except for one pervasive issue of law relating to burden of proof, their own discrete facts. What needs to be set forth as pertinent background for the entire case is as follows. The taxpayer, whose most recent period of work in the Dominican Republic stretched from 1944 to 1962, first encountered United States tax difficulties in a suit begun in 1958, in which the government laid claim to allegedly unreported income for the years 1951-1956, subsequently expanded in a 1960 suit to encompass income for 1957-1958. Records of taxpayer's costs and equipment purchases in connection with various construction contracts being allegedly non-existent, taxpayer and the government finally agreed to a percentage of completion method of computing profit on officially published contracts. *See* 26 C.F.R. § 1.451-3(b)(1). One-eleventh of receipts (equivalent to costs plus 10 per cent) estimated on all contracts for a given year was deemed profit. This

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the government thus could only tax the engineer on one-half of his income. The parties stipulated in this suit to abide by that prior ruling and for the government to reduce its assessments for the years in question to conform. Although we here use always the total figures for receipts or expenses, our decision is, of course, subject to the uncontested prior ruling and the stipulation. We refer to the engineer throughout this opinion as the taxpayer.

formula would have resulted in substantial tax obligations during the period 1951-1958, *see United States* v. *Rexach*, 185 F. Supp. 465 (D. P.R. 1960), but for a single happenstance. In late May of 1961, the taxpayer paid $1,552,000 in taxes to the Dominican Republic for the years 1951-1958 and claimed a tax credit against his United States tax for those same years. This payment and the foreign tax credits it created, *see United States* v. *Rexach* , 200 F. Supp. 494 (D. P.R. 1961), enabled taxpayer to reduce his tax liabilities to $78,866.01 plus interest (or $121,132.13) for the years 1951-1956, and to bring about the dismissal of the suit for taxes for 1957-1958.

With the dictator's assassination in late May, 1961, a new chapter began. Not only was taxpayer's existing contract with the Dominican Republic cancelled, but he was sued on past contracts and a sequestrator took possession of all of taxpayer's assets. Taxpayer, who had renounced his United States citizenship in 1958 during the earlier litigation, attempted to regain it, claimng that he had been coerced in his renunciation by Trujillo, who feared that taxpayer's continuing involvement in tax litigation with the United States would reveal taxpayer's kickbacks to Trujillo of $10,000,000 of some $30,000,000 of contracts awarded over the prior 25 years. Taxpayer was ultimately successful in regaining his U. S. citizenship and passport, and filed an amended return for 1958 and returns for 1959-1961.

Internal Revenue personnel, attempting to audit these returns, spent several weeks in the Dominican Republic, saw a limited amount of records, learned of several previously unreported contracts and of the circumstances surrounding the $1,552,000 tax credit previously taken. As to the latter, it was found that in 1961 Trujillo had paid taxpayers $1,552,000 allegedly claimed as losses on the Boca Chica project, which was completed in 1958, and that it was this same sum which taxpayer paid back to Trujillo and took as a tax credit against his earlier United States

tax liability. In fact, the entire transaction was solely on paper; no money ever changed hands. These discoveries led to a suit seeking to reopen the cases for the years 1951-1956 and 1957-1958 because of fraud. The government, which at that trial relied only on the undiscovered contracts, once again was unsuccessful, the court finding that the taxpayer's failure to list the contracts was the result of an honest mistake and made in good faith. *United States* v. *Rexach*, 41 F.R.D. 180 (D. P.R. 1966). In the meantime, the United States assessed deficiencies, including fraud penalties, against taxpayer of $662,052.62 for 1959 and $2,272,042.95 for 1961, and brought the instant suit in 1964.

The complaint, amended twice, sought taxes on unreported income and penalties for the tax year 1959 stemming largely from two construction contracts, one for a customs house building and the other for facilities at the port of Azua; and for the tax year 1961 from a dredging project on the Yuna River and the $1,552,000 payment on account of the Boca Chica project. A trial in 1966 produced no decision when the trial judge retired. Subsequent skirmishing and a certified appeal led to our decision that taxpayer was liable for taxes during the period of his later-revoked renunciation of citizenship. *Rexach* v. *United States*, 390 F.2d 631 (1st Cir.), *cert. denied*, 393 U.S. 833 (1968). A second trial took place in 1970 on the earlier record, supplemented by additional evidence governed by a stipulation.[2] The district court held that the government,

[2] The stipulation, in essence, provided that the court should consider only the record and the evidence previously adduced at the earlier trial, plus "such relevant testimony [of the government agent] concerning the records of defendant . . . which were recovered from the Dominican Government after the prior trial and which was [sic] made available for inspection and examination of [the government]" and "such relevant testimony and other evidence as defendant wishes to present with respect to the alleged losses incurred by defendant as a result of the seizure and receivership of his Dominican business and properties by the Dominican Government, from theft and shipwreck, and any depreciation of said properties."

having the burden of proof, failed to establish deficiencies in reported income for the customs house, Azua, and Yuna projects; that the 1961 payment for the Boca Chica contract merely offset, as alleged by taxpayer, greater earlier losses on the project; that the taxpayer was entitled to deduct certain additional items for depreciation and theft; and that no fraud on the part of the taxpayer had been proven. *United States v. Rexach*, 331 F. Supp. 524 (D. P.R. 1971).

We shall discuss, in order, the issue of burden of proof, which affects both tax years; the disposition of the major 1959 items—the Azua and customs house projects; the disposition of the major 1961 items—the Boca Chica and Yuna projects; and the remaining issues relating to depreciation, theft loss, and fraud.

I. Burden of Proof

From what has been already said about the protracted nature of this controversy, the remoteness of events, and the difficulty of access to masses of documentary evidence in the Dominican Republic, it is obvious that a determination as to which party is to bear the burden of proof is of fundamental significance.

The district court stated that "It is elementary that in a suit to collect taxes the Government occupies the status of a private litigant and the burden of proof is upon it." 331 F. Supp. at 538. Although recognizing that the Commissioner's assessment itself establishes a prima facie case, the court believed that only "the burden to go forward", with "competent and relevant evidence from which [it] can be found that he did not receive the income alleged in the deficiency", was imposed on the taxpayer. It ruled that when this burden is met "the burden of proof shifts back to the Commissioner to prove the existence and amount of the deficiency", citing *Foster* v. *C.I.R.*, 391 F.2d 727, 735 (4th Cir. 1968). *Id.* The government contends that this ruling is in conflict with long-standing precedent in this and other circuits. We agree.

At least since 1942, it has been the law in this circuit that "where a taxpayer petitions the Board for redetermination of a deficiency found by the Commissioner, the taxpayer has the burden of proving that the Commissioner's determination was wrong." *Chicago Stock Yards Co.* v. *C.I.R.*, 129 F.2d 937, 948 (1st Cir. 1942), *rev'd on other grounds*, 318 U.S. 693 (1943). *See also Sharaf* v. *C.I.R.*, 224 F.2d 570, 572 (1st Cir. 1955); *General Aggregates Corp.* v. *C.I.R.*, 313 F.2d 25, 27 (1st Cir. 1963); *C.I.R.* v. *Young Motor Co.*, 316 F.2d 267, 270 (1st Cir. 1963); *Worcester* v. *C.I.R.*, 370 F.2d 713, 715 (1st Cir. 1966). This rule for taxpayer-initiated suits is premised on several factors other than the normal evidentiary rule imposing proof obligations on the moving party: the relevant prior Supreme Court precedent indicative, if not determinative of the issue, *Wickwire* v. *Reinecke*, 275 U.S. 101, 105 (1927); *Welch* v. *Helvering*, 290 U.S. 111, 115 (1933); *Helvering* v. *Taylor*, 293 U.S. 507, 515 (1935); *Bull v. United States*, 295 U.S. 247, 260 (1935); the presumption of administrative regularity; the likelihood that the taxpayer will have access to the relevant information; and the desirability of bolstering the record-keeping requirements of the Code.

Whatever uncertainty may once have existed because of our use of the general phrase "burden of proof" was dispelled by our opinion in *United Aniline Co.* v. *C.I.R.*, 316 F.2d 701 (1st Cir. 1963). We there explicitly rejected the suggestion of the Fourth Circuit in *Stout* v. *C.I.R.*, 273 F.2d 345, 350 (4th Cir. 1959), that the Commissioner's assessment merely shifts to the taxpayer the burden of going forward with evidence, and disapproved the use of the term "presumption" because of the danger, illustrated in *Clark* v. *C.I.R.*, 266 F.2d 698 (9th Cir. 1959), of misleading courts into believing that if the taxpayer introduced evidence from which it "could" be found that the assessment was erroneous, the burden of proof was placed on the Commissioner. We unambiguously stated that whether or not reference was made to a presumption, it must be made

clear that "the taxpayer never loses the burden of proving the Commissioner's determination erroneous." 316 F.2d at 704; *see also n.* 4, "Presumption or no, the burden of proof never shifts."

The district court in finding that the burden can shift to the Commissioner relied on *Foster, supra,* a subsequent Fourth Circuit deficiency case, which said that the initial burden on the taxpayer is merely procedural, requiring only evidence from which it could be found that the deficiency was wrong, and that once met, the burden was on the Commissioner to prove the existence and amount of the deficiency. That decision rested explicitly on such earlier cases as *Stout* and *Clark, supra,* which we had equally explicitly considered and rejected in *United Aniline.* We have been presented with no reasons why we should reconsider our rejection of *Stout, Clark* and their progeny, and our holding in *United Aniline.* Therefore, insofar as *Foster* may be deemed inconsistent with the rule enunciated in *United Aniline* and followed in the other circuits,[3] we reject *Foster*

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[3] *See, e.g., United States* v. *Lease,* 345 F.2d 696 (2d Cir. 1965); *Lesser* v. *United States,* 368 F.2d 306 (2d Cir.. 1966) (en banc); *Diamond Bros. Co.* v. *C.I.R.,* 322 F.2d 725 (3d Cir. 1963); *Psaty* v. *United States,* 442 F.2d 1154 (3d Cir. 1971); *Bar L Ranch, Inc.* v. *Phinney,* 426 F.2d 995 (5th Cir. 1970); *Liddon* v. *United States,* 448 F.2d 509 (5th Cir. 1971); *Thrash* v. *O'Donnell,* 448 F.2d 886 (5th Cir. 1971); *Weir* v. *C.I.R.,* 283 F.2d 675 (6th Cir. 1960); *Ehlers* v. *Vinal,* 382 F.2d 58 (8th Cir. 1967); *Plisco* v. *United States,* 306 F.2d 784 (D.C. Cir. 1962).

In fairness to *Foster* and the cases it cites, we are not persuaded. that they are necessarily in conflict with the prevailing rule. What has led to difficulty has been the language of those cases, tending to confuse or obscure two subsidiary components of the burden of proof rule. First, language regarding the Commissioner's obligation to prove the existence and amount of the deficiency apparently stems from *Helvering* v. *Taylor, supra,* which held that once a taxpayer in a deficiency case has borne his burden of proving the Commissioner's determination invalid, he has no further obligation to show that no money is owed, or, if some, how much. But this happy state is reached only if the predicate is fulfilled, i.e., *only if*

and reaffirm our holding in *United Aniline* that in a deficiency or refund suit, the burdens of going forward and of ultimate persuasion are always on the taxpayer and never shift to the Commissioner.

Taxpayer does not challenge the holding of *United Aniline* but rather suggests that the rule may be different, as the district court's opinion indicated, when, as here, the government sues to collect taxes. This proposal, that the burden of proof shifts when the government is the moving party, either in a collection suit or on a counterclaim to a taxpayer refund suit, has been rejected by other circuits, *Lease, Lesser, Psaty, Bar L, Liddon, Thrash, Plisco, supra,*[4] and for sound reasons. To place the burden of persuasion on the government when it moves to collect assessed taxes would encourage taxpayer delay and in-

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the taxpayer has carried his burden of persuading the factfinder that the deficiency was erroneous. 293 U.S. at 513, 514, 515. *Foster* and its predecessors may be read as only reiterating the concept. Second, language relating to the disappearance of the "presumption," found in *Clark, Cohen* v. *C.I.R.*, 266 F.2d 5, 11 (9th Cir. 1959) and more recently in *Herbert* v. *C.I.R.*, 377 F.2d 65, 69 (9th Cir. 1967), would seem to refer not to a shifting of the ultimate burden of persuasion to the Commissioner but to the fateful consequences for him if, in the face of taxpayer's initial presentation of evidence proving the deficiency erroneous, there is added to the record (whether from the Commissioner's or the taxpayer's witnesses or documents) no contradictory evidence supporting the bare assessment. *See Sharaf, supra. Lawrence* v. *C.I.R.*, 143 F.2d 456 (9th Cir. 1944), the other case cited by the district court, stands for this proposition.

[4] *But see United States* v. *Molitor*, 337 F.2d 917 (9th Cir. 1964). In *Molitor*, the government itself suggested that it had the ultimate burden, a proposition the court was understandably not concerned with rejecting. Its lengthy citation of *United States* v. *Rindskopf*, 195 U.S. 418 (1881), does not seem to us dispositive of the issue because the suit there was in part against third parties, sureties on a distiller's bond, a condition of which was compliance with all relevant laws, as against whom the general tax burden of proof would seem unfair.

action, thereby imposing on the government the costs and burdens both of borrowing money to meet the gap of unpaid taxes and of initiating litigation. It would also undermine the record-keeping requirements, thereby making the government's case more difficult if not impossible to establish. We therefore hold that in tax collection suits or on government counterclaims, as in tax deficiency or refund suits, the burdens of both going forward and ultimate persuasion are on the taxpayer.[5]

Since we find that the district court employed the wrong burden of proof rule, we must remand. We are, however, unable to determine from the record before us whether the taxpayer,[6] at the time that he prepared and presented evidence, labored under the same misconception as the deciding court. We have found some statements, most significantly in the opening remarks of both parties at the first trial, which strongly suggest that the case was tried by judge and parties alike under the assumption that the taxpayer had the burden of disproving the assessment, the government being required to prove only the fraud allegations. We do not, however, have before us the briefs and memoranda of law submitted by the parties over the years to the district court, which might elucidate this problem. Nor, of course, do we have a record of any informal discussions between the parties or conferences with the court. We therefore are not in a position to decide whether the district court, on remand, may properly restrict its reconsideration to the existing record, or whether the taxpayer reasonably relied on a mistaken understanding of the dis-

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[5] Of course, as to fraud assessments, both burdens are always on the government, see 26 U.S.C. § 7454 (a); *Worcester, supra*, 370 F.2d at 717, which the court recognized.

[6] Since, if the government thought it carried the burden it would presumably have made a more extensive effort than necessary under the proper rule, the only circumstances which could have prejudiced either party, would seem to be the taxpayer's belief that the government bore the evidentiary burden.

tribution of evidentiary burdens so that he must, in fairness, be permitted to supplement the record, as the government would then also be entitled to do, now that the mistake has been corrected. Thus, on remand, the district court should first decide, on the transcripts and briefs if possible, and after hearing if necessary, whether the taxpayer suffered as to some or all of the issues from an erroneous, though reasonable, misunderstanding of his evidentiary burden and therefore whether the record should be reopened. We recapitulate, at the close of this opinion, the implications for both parties of a closed, versus an open, record.

II. 1959 Items—Deductions for Kickbacks on the Azua and Customs House Contracts

Taxpayer reported in his 1959 return contract payments on two construction projects in the Dominican Republic, one at the Port of Azua and the other a customs house in Ciudad Trujillo. The Azua contract was awarded in early 1956 and the project completed 35 months later in March, 1959, taxpayer receiving a basic payment of $4,750,000. The customs house contract was awarded in August, 1958, and construction terminated 15 months later in October, 1959, taxpayer receiving a basic payment of $7,000,000. Taxpayer and the Commissioner had agreed, in connection with earlier litigation, including these same contracts, to employ an accounting method whereby the original gross contract price was divided by the number of months duration for each contract, thereby giving an estimated monthly payment on the assumption that the project had progressed to completion at a constant rate. After all monthly payments in a tax year were totalled, profits were computed as 1/11th of the total, the equivalent of a 10 per cent profit margin. Taxpayer chose this same method here when he filed his 1959 return and accordingly a profit margin of 10 per cent was claimed for the sums assigned to that year. This accounting method, though not

the particular profit margin, is essentially identical to the percentage of completion method which is explicitly authorized by the Commissioner, 26 C.F.R. § 1.451-3(b)(1).

Auditing of taxpayer's 1959 return was made by sending an Internal Revenue agent and an engineering expert to the Dominican Republic to examine his records which had been sequestered by the post-Trujillo government. Only a limited viewing of the records and more extensive inspection of some of the actual construction projects, including the Azua project but not the customs house project, was permitted. From interviews with workmen, supervisors, material vendors, local engineers and contractors and from the actual inspection, the engineer estimated that "the aggregate cost of all work will not exceed 40 to 45 percent of the contract payments." Working from a 42.5 per cent figure, the Commissioner filed suit against taxpayer, alleging that a profit of 57.5 per cent was earned on the Azua and customs house contracts and seeking the additional tax thereon.

Taxpayer's defense to these claims is three-fold. First, he alleges that since the government adopted the 10 per cent profit rule for the years 1951-1958, which included part of the work on the Azua and customs house contracts in those years, it is estopped from prohibiting him from using the same formula for these projects in 1959. He particularly relies on *Tait* v. *Western Maryland R.R. Co.*, 289 U.S. 620 (1933) and *Thomas* v. *C.I.R.*, 324 F.2d 798 (5th Cir. 1963), which the district court cited in sustaining taxpayer's position. Those cases, however, do not help him. In *Tait*, a second court which was merely determining tax liability based upon the same evidence presented to a first court was foreclosed from making different factual findings. And in *Thomas* the court expressly stated that where the operation of a farm for one year was found by a jury to be as a business for profit, another court may, while giving consideration to that finding, determine upon substantial evidence that for subsequent years the farm was not run as a bona fide business.

Both these cases recognize the basic rule that "each year is the origin of a new liability and of a separate cause of action", *C.I.R.* v. *Sunnen*, 333 U.S. 591 (1948). This is most relevant here since "the controlling facts and applicable legal rules" are said to have changed in this litigation as compared to the prior cases dealing with the earlier years 1951-1958. *Id.* at 600. Specifically considering only a change in facts, sufficient to fall within the *Sunnen* rule, the 10 per cent profit margin here for the years 1951-1958 was selected by the Commissioner as the usual amount of profit to be expected on such construction contracts, especially since taxpayer professed to be without any business records. Something new was added by the visit to the Dominican Republic, where inspection of some of taxpayer's books and actual work was permitted in 1962. This revealed important new evidence. No impressive policy reason has been offered to preclude the government from using this evidence in determining taxpayer's 1959 tax liability.

In any event, the most basic premise for utilizing the concept of collateral estoppel—that there be a prior judgment on the merits—is absent in this case. *United States* v. *International Building Co.*, 345 U.S. 502 (1953). The stipulation as to a 10 per cent profit, which ended the government's suits for taxes due in 1951-1958, was not a decision on the merits that such profit had in fact been realized, but rather only a best estimate, specifically limited to those years and accepted by both sides, based on the then-available information. On the facts of this case, any invocation of estoppel would constitute a misapplication of equitable principles underlying the doctrine.[7]

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[7] We also reject taxpayer's argument of "quasi-estoppel" which is based essentially on the consideration of equitable factors. First, we note that this doctrine has been expressly rejected in this circuit. *Ross* v. *C.I.R.*, 169 F.2d 483, 494 (1st Cir. 1948) (Frankfurter, Circuit Justice); 10 Mertens Law of Federal Income Taxation ¶ 60.04 at 16, n. 50 (1972). Moreover, as it is grounded in equity,

Second, taxpayer alleges that the 57.5 per cent profit fails to take account of the 33⅓ per cent kickback made to Trujillo. Aside from the fact that taxpayer had previously stated at a trial that he had never made any kickbacks to the Dominican Republic, both he and the district court wrongly interpreted the 1959 amendment to § 162 of the Internal Revenue Code. Section 5(a) of the Technical Amendments Act of 1958 added a new paragraph to read:

> *"Improper Payments to Officials or Employees of Foreign Countries.*—No deduction shall be allowed under subsection (a) [of section 162 relating to ordinary and necessary business expenses] for any expenses paid or incurred if the payment thereof is made, directly or indirectly, to an official or employee of a foreign country, and if the making of the payment would be unlawful under the laws of the United States, if such laws were applicable to such payment and to such official or employee." 26 U.S.C. § 162(c).

The effective date of this amendment is stated as follows:

> "The amendment . . . shall apply only with respect to expenses paid or incurred after the date of the enactment of this Act [September 2, 1958]. The determination as to whether any expense paid or incurred on or before the date of the enactment of this Act shall be allowed as a deduction shall be made as if this section had not been enacted. . . ." P.L. 85-866, § 5(b) (Sept.

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we do not see how the government can be said to have "profited" from the prior stipulation as to a 10% profit margin in 1951-1958, nor do we see here any detriment to taxpayer, other than payment of taxes lawfully due, resulting from the Commissioner's recent evaluation of profits earned on these contracts in 1959. *See generally*, Lynn & Gerson, *Quasi-Estoppel and Abuse of Discretion as Applied Against the United States in Federal Tax Controversies*, 19 Tax L. Rev. 487, 489 n. 10 (1964). We must conclude that taxpayer's reliance on this doctrine is nothing more than a restatement of his already rejected claim of collateral estoppel.

2, 1958), U.S. Cong. & Admin. News, 85th Cong., 2d Sess., 1927-1928.

The district court reasoned that since taxpayer's obligation to kick back one-third of the contract price was "incurred" prior to September 2, 1958, the deduction should be allowed "as if this section had not been enacted."

The relevant language for taxpayer, however, is not "expenses . . . incurred," but rather "expenses paid." In referring separately to these times, which may or may not coincide in some transactions, the statute avoids redundancy only if Congress is understood as merely recognizing that there are generally two systems of accounting followed by most taxpayers—the cash receipts and disbursements method and the accrual method. *See generally* 26 C.F.R. § 1.446-1(c). For the taxpayer on the cash receipts or disbursements method, or other permissible methods which focus upon the actual exchange of cash, 26 C.F.R. § 1.446-1(c)(iii), cash payments made prior to September 2, 1958, which might have been permitted to be deducted absent the new amendment on kickbacks, were not to be affected by the new provision. For the taxpayer on the accrual method, or other methods where the time the obligation is incurred is important, obligations incurred prior to September 2, 1958, no matter when paid, were not to be affected.

The district court found that it was not proven whether the kickbacks were made before or after September 2, 1958. Under our interpretation of the statute, and the accounting system used by taxpayer, this unknown fact is irrelevant. Taxpayer, having selected the "percentage of completion method" as to his long-term contracts, was permitted to deduct only "all expenditures *made* during the taxable year in connection with the contract." 26 C.F.R. § 1.451-3(b)(1). [Emphasis added.] If all of the kickbacks, or any portions thereof, were made prior to September 2, 1958, they could have been deducted only in those years under

§ 1.451-3(b)(1) and the new statute of course would not affect that case. But to the extent that any kickbacks were made in 1959, the taxable year here in question the new law clearly forbids a deduction based thereon. Thus, the timing of the kickback payments on the Azua and customs house contracts does not change the result that there can be no tax benefit to taxpayer in 1959.[8]

Last taxpayer claims that the government has not met its burden of proof to show that his profits were 57.5 per cent on the Azua and customs house contracts. Though to be sure, the Commissioner's failure to specify in detail the persons interviewed or documents relied upon in regard to each project leaves something to be desired, especially since only the Azua project was actually viewed, the government, as we have ruled earlier, did not have the burden of proof. Moreover, coming at the issue from another direction, there were admitted kickbacks which consumed one-third of the contract price, and on both projects taxpayer paid income taxes to the Dominican Republic in 1957 and 1958 based on the determination that his profits were equal to 25 per cent of his gross income. The kickbacks and acknowledged profit together approximated a 58 per cent assessed profit since the kickbacks, as we have said, cannot be deducted.[9]

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[8] We also reject the district court's ruling that the new amendment was inapplicable because taxpayers' payments were not to an "official or employee of a foreign country", but rather to the government of that country itself, embodied in dictator Trujillo. We see no logic in disallowing deductions for payments to a top elected official but in allowing such for payments to one who has seized absolute power. Whatever other governmental programs may be said to have subsidized dictators, Congress cannot be said to have chosen this particular tax route.

[9] We hasten to add that our reading of the record indicates the Dominican tax was not being used, despite taxpayer's contention, as a basis for the United States assessment, but rather as an additional check on the reasonableness of the Commissioner's findings.

However inexact the government's assessment might be, on the present record the taxpayer must be found not to have carried his burden with regard to the Azua and customs house contracts. As he admits in his brief to this court, he presented no evidence regarding the actual profits earned on those contracts; he merely asserted his opinion that no contractor could earn the percentage assessed by the government, that 5 to 6 per cent was normal, and that he lost money on the customs house contract. As a matter of law, this was inadequate evidence of the deficiency's incorrectness. Thus, unless the district court finds, upon remand, that the taxpayer, as stated earlier, erroneously and reasonably relied on the government having the burden of proof, the government's assessment must stand.

III. 1961 Items—Boca Chica and Yuna Contracts

A. Boca Chica Contract Payment

In the years 1955-1958, the taxpayer performed and completed work on a contract for the construction of a pier, road and warehouse and the dredging of the entrance channel of the bay at Boca Chica in the Dominican Republic. He received in those years total payments of $3,880,000. As stated earlier, it was determined by the Commissioner and stipulated between the parties that the taxpayer earned profits of 1/11th of the contract payments received in the years of receipt (equivalent to costs plus 10 per cent). In a deposition given before the stipulation, taxpayer asserted that in fact he had made no profit on the Boca Chica contract but suffered a loss in excess of $1,000,000. He claims that he consented to the Commissioner's computation because of fear for his personal safety and future standing with Trujillo were he to divulge the alleged 33⅓ per cent kickback payments which were a major part of his expenses. At that time he had pending with the Trujillo government a claim for some $3,750,000 for compensation for the extra cost of dredging 1,000,000 cubic yards of rock, which had not been anticipated in the original contract and

which all, including the government's expert, agree is far harder and more expensive to remove than the silt and other softer materials which had been predicted.

In 1961, just before Trujillo's death, as we have earlier noted, the dictator approved a settlement of this claim in the amount of $1,552,000, which taxpayer immediately paid back to the Dominican government for taxes allegedly due for the years 1951-1958. That payment was then successfully claimed by taxpayer as a foreign tax credit against his American tax liabilities for those years. The government, having, in its second amended complaint, elected to treat the $1,552,000 payment as extra compensation rather than a sham, claims that all of the payment was taxable income of the taxpayer in 1961. The taxpayer below claimed and personally testified that he had in fact incurred a substantial loss on the Boca Chica contract, in excess even of this large payment. The district court, accepting his testimony, and finding that he had incurred substantial losses "manifestly unjust and not in accordance with law, to now in those earlier years, which were only partially compensated for by the 1961 payment, held that it would be assess a federal income tax on any part of said payment." 331 F. Supp. at 542.

The government contends that under settled principles of tax law the payment in 1961 was then taxable as income, even if it was in fact compensation for expenses incurred in a prior tax year; and that in any case, the prior stipulated 1/11th rate of profit on the contract in 1955-1958, through the operation of *res judicata* and collateral estoppel, bars the present claim that taxpayer in fact lost money in the performance of that contract. The taxpayer argues that the prior determination was merely based on a stipulation into which the taxpayer was coerced and was due to a mistake of law on the Commissioner's part; that it therefore does not prevent present examination of the actual results of the Boca Chica contract; and that sub-

stantial evidence supported the district court's finding of a substantial loss not fully compensated. While, for reasons already indicated, the taxpayer might not be estopped from proving that he in fact suffered a loss from the contract as to which he had previously stipulated a profit, *United States* v. *International Building Co., supra,* we conclude that under existing procedent, even such proof cannot overcome the government's assessment of the 1961 payment as income in that year.

In 1931, the Supreme Court, in a seminal case frequently since reaffirmed, held, on nearly identical facts, that a later payment in compensation for expenditures made on a contract which had resulted, during its performance, in net tax losses, was taxable as income in the year of its receipt. *Burnet* v. *Sanford & Brooks Co.,* 282 U.S. 359 (1931). The taxpayer there performed a contract with the United States government to dredge the Delaware River. In each of the four years of the contract's performance, 1913-1916, the taxpayer added to the gross income for each year the payments made on the contract in that year and deducted its expenses paid that year in performing the contract. In three of those years, the expenses exceeded the payments; the total loss on the contract was $176,271.88. A judgment for the taxpayer for that sum plus interest for breach of warranty as to the character of the material to be dredged was affirmed by the Supreme Court in 1920. In the subsequent tax deficiency suit, the Court held that the Commissioner properly assessed all of the judgment as an addition to gross income. The Court stated that the recovery in 1920 was gross income for that year, even though "it equalled, and in a loose sense was a return of, expenditures made in performing the contract." 282 U.S. at 363. "The excess of gross income over deductions did not any the less constitute net income for the taxable period because respondent, in an earlier period, suffered net losses in the conduct of its business which were in some measure attributable to expenditures made to produce the

net income of the later period." *Id.* at 364. The Court's reasoning was that the tax laws proceeded under an annual system of accounting in which all receipts and payments (or accruals of same) in one year were to be counted for purposes of computing the tax for that period. The Court concluded that while "a different system might be devised by which the tax could be assessed, wholly or in part on the basis of the finally ascertained results of particular transactions", *id.* at 365, Congress had not so chosen and its choice of annualization-of-income was not unconstitutional.

Although the Supreme Court has not since *Sanford* decided another case of precisely its species, it has repeatedly cited it with approval, when dealing with tax transactions of a similar ilk, for its annualization-of-income principle that payments made and received be accounted for only in the year of the payment or receipt. *See Guaranty Trust Co.* v. *C.I.R.*, 303 U.S. 493, 498 (1938); *Dobson* v. *C.I.R.*, 320 U.S. 489, 504 (1943); *Security Mills Co.* v. *C.I.R.*, 321 U.S. 281, 286 (1944); *Lewyt Corp.* v. *C.I.R.*, 349 U.S. 237, 250 (1955). Most analogous are its rulings under the "claim of right" doctrine, launched the year after *Sanford* in *North American Oil* v. *Burnet*, 285 U.S. 417 (1932). There the Court established the rule that "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income . . . even though it may still be claimed that he is not entitled to retain the money and even though he may still be adjudged liable to restore its equivalent." *Id.* at 424. *See also United States* v. *Lewis*, 340 U.S. 590, 592 (1951); *United States* v. *Skelly Oil Corp.*, 394 U.S. 678, 680-81, 684 (1969). Just as one who presently receives payment on a claim must consider it as income for tax purposes though it appears, even at the time of receipt, that he may later have to pay back some or all of that receipt, so one who in a prior year had losses which are now compensated must consider the later payment as income for tax purposes.

Lower courts have followed *Sanford* when confronted with analogous facts. In *C.I.R.* v. *John Thatcher & Son,* 76 F.2d 900 (2d Cir. 1935), the court held that a contractor could not deduct as a loss the extra expenses incurred on a contract because of the default of his subcontractors, in the year in which his suit on the default was finally adjudicated against him, but only in the year when actually paid. In so concluding, the court stated that had the suit been successful, "such recovery would have been income in the year when received" citing *Sanford* which it thought governed the case before it. 76 F.2d at 901. More recently, in *H. W. Nelson Co.* v. *United States,* 308 F.2d 950 (Ct. Cl. 1962), the Court of Claims held that a payment received in 1941 as settlement of a judgment in a suit arising from a contract performed and completed in the years 1928-1931 was taxable as income in 1941 under *Sanford* even though the payment constituted recoupment of expenses in the performance of the contract. The court noted that the only difference between *Nelson* and *Sanford* was that in the former the taxpayer used the completed contract basis of accounting and in the latter the annual cash basis of accounting was employed. It found this difference without significance because the contract was completed in 1931, at which time, under the applicable or any other system of accounting, all expenses and receipts under the contract would have been taken into account.

This case is precisely governed by *Sanford* and *Nelson.* Taxpayer performed and completed a contract for dredging between 1955 and 1958 and his tax liability for those years was calculated, under the percentage of completion formula, 26 C.F.R. §1.451-3(b)(1), according to the receipts and expenses in those years. His receipt in 1961, even though arguably a recoupment for losses incurred in those prior years, must be considered as income in 1961, regardless of the accounting system used in the years of performance, if the annual accounting principle is to be maintained and Congress' rejection of a system of reopening to assess

the final results of a particular transaction or contract is to be upheld.

Although neither party has briefed or argued the point, we have considered whether the so-called "tax benefit" rule applies to this amount which we have found is includible as gross income in 1961. Under that rule, the amounts recovered in a later year for losses or expenditures previously deducted are excludable from gross income to the extent that the prior deductions did not result in a tax benefit to the taxpayer in that prior year. 26 U.S.C. § 111; 26 C.F.R. § 1.111-1. Assuming without deciding that the type of losses here alleged are subject to the tax benefit rule, *compare Lloyd Faidley* v. *C.I.R.*, 8 T.C. 1170 (1947) *with* Plumb, *The Tax Benefit Rule Today*, 57 Harv. L. Rev. 129, 130 (1943), we still must conclude that taxpayer may not invoke the rule, since he did not actually claim as deductions in the prior years the losses which he now alleges are compensated by the 1961 payment.

As we have previously held, "[U]nder the rule contended for an amount recovered can be excluded from gross income in the year of recovery only when the amount involved was deducted in some prior year." *Mathey* v. *C.I.R.*, 177 F.2d 259, 264 (1st Cir. 1949). The Tax Court came to the same conclusion in *First National Bank* v. *C.I.R.*, 22 T.C. 209 (1954), *aff'd without opinion*, 221 F.2d 959 (2d Cir.), *cert. denied*, 350 U.S. 887 (1955), reasoning that had Congress, and we might add the Commissioner, intended to have applied the rule to deductions for prior years which were not but could then have been claimed, reference would have been made to "deductions which could have been claimed" and "deductions which would not have resulted in a reduction of the taxpayer's tax" rather than to "deductions or credits allowed", "items . . . for which a deduction or credit was allowed for a prior taxable year" and "deductions, which did not result in a reduction of . . . tax". 26 U.S.C. § 111(b), 26 C.F.R. § 1.111-

1(a). Sound policy would also seem to dictate this common sense reading of the statute and regulation. Were taxpayers free to claim a recovery exclusion for expenditures allegedly made in a prior year but not actually claimed, the Commissioner and the courts would be required to recompute prior, frequently very old tax returns, *see First National Bank, supra,* based on stale and often, as here, inadequate evidence. Moreover, permitting such a belated claim of prior allowable deductions could produce fraudulent claims of prior expenses to improve the taxpayer's status in later years of higher income. For these reasons, we reaffirm our holding in *Mathey* that the tax benefit rule only applies when the losses later recovered were actually deducted in the relevant prior years.

B. *The Yuna Contract*

Taxpayer's 1961 return included $408,934.72 in expenses on the Yuna contract which were offset against contract payments of $200,000, thereby producing a loss of $208,-934.72. The government rejected this claim loss and applied its 57.5 per cent profit calculation to this contract. While, because of the reliance placed by the district court on its view that the government bore the burden of proof, this issue must be reconsidered, we think it proper to comment on several evidentiary problems.

The Yuna contract was executed on April 9, 1961, and contemplated payments of $4,700,000 for dredging and other work in reclamation of a large land area and making the Yuna and Barracote Rivers navigable. After dictator Trujillo was assassinated on May 30, 1961, this contract was cancelled by the new government on July 14, 1961. Taxpayer requested additional payment, other than the initial $200,000, from the new government to cover his allegedly greater costs. He testified that the Secretary of Public Works for the Dominican Republic subsequently concluded that he was entitled to $800,000 for dredging costs, but taxpayer is presently contesting that amount

through diplomatic channels as being too low. The alleged losses noted in his testimony, scattered throughout the trial, include the approximate expenses of items such as wages and supplies, and estimates of around 40 cents a cubic yard for the actual dredging.

Additional evidence was presented to justify taxpayer's claims in the form of a so-called accounting register, labeled, quite significantly we believe, "Income and Disbursements Book—Yuna Project—Period: April 1, 1961—March 31, 1962." No one could explain why and how this book in contrast with all of taxpayer's other sequestered records, was removed from the Dominican Republic in the early 1960's. The only identification of the register was by taxpayer who said that he ordered its preparation at the time of the project, and that it was in the handwriting of his accountant. The entries in the register total $545,310.66, but taxpayer deducted only $408,934.72, an amount determined by the deceased accountant. Taxpayer could not say exactly which items were included by the accountant, and which were not, in the amount deducted. Nevertheless, since taxpayer's primary records from which the register was allegedly prepared were sequestered after the death of Trujillo, and were unavailable at the commencement of the unfinished trial begun in 1966, the late Judge Ruiz Nazario admitted the register into evidence.

At the latest stage of these proceedings before the district court, the government moved to strike the register from evidence. Its basis was that, as a result of its agent examining, in 1967, the primary records held in the Dominican Republic, which had been returned to taxpayer's control after the earlier proceedings were suspended, it had discovered numerous items listed as actual expenses for the Yuna project which were, in fact, admittedly personal expenses of taxpayer. The agent brought to Puerto Rico only a small part, some 150 pounds, of these primary records as samples to compare with the register and he found a total of approximately $41,000 listed as business expenses to be per-

sonal in nature. Relying upon the claimed unreliability of the register, the present availability of the primary records, and the alleged wrongful initial admission of the register into evidence, the government moved that it now be struck.

Whatever doubts we may have as to the correctness of the original admission into evidence of the register, we think that the trial court erred in not striking it after the testimony of the government agent. To be sure, where there are a large number of documents which would be impracticable to produce in court and read aloud, it has been said that a summary of the documents should be admissible. 4 Wigmore on Evidence § 1230, at 434 (1940). At a minimum, however, "the mass thus summarily testified to shall, if the occasion seems to require it, be placed at hand in court, or at least be made accessible to the opposing party, in order that the correctness of the evidence may be tested by inspection if desired, or that the material for cross-examination may be available." *Id.* Thus, for example, we approved of such a procedure in *Yoffee* v. *United States*, 152 F.2d 570, 570 574 (1st Cir. 1946), in part because the ledger sheets there were present throughout the trial. *See also* Rule 1006 of the proposed Rules of Evidence for United States Courts and Magistrates.

In the instant case there were hundreds, perhaps thousands, of documents relating to the Yuna project which were purportedly summarized by the deceased accountant in the register. Taxpayer permitted inspection of these documents by the United States agent in October and December of 1967 in the Dominican Republic where, owing to the vast numbers involved, only samples were taken back to Puerto Rico for the more detailed analysis which subsequently revealed the numerous personal expenses included in the register. However, taxpayer chose to leave the remainder of these documents in the Dominican Republic and, quite understandably, objected when the government served him, on August 17, 1970, during a three-week recess in the instant trial, with a notice to produce all of those documents

with respect to relevant bank accounts involving the Yuna project.

Though the government's request for production came lamentably late, we refer to our discussion of burden of proof. Were the government to have had that burden, its delinquency in assuring the presence of all relevant records could properly have been held against it. But the burden was, as we hold, that of taxpayer, who might therefore have been expected to produce such records or have them more easily accessible. Taxpayer left those records in the Dominiman Republic at his peril. Even though the original primary documents might properly have been summarized and thus admitted into evidence, we think that in the circumstances of this case where there is grave doubt as to the reliability of the register's summary, and the missing original writings in dispute are the very foundation of the claim, greater access to these primary records during trial was required than that afforded by taxpayer. *See generally Sylvania Products, Inc.* v. *Flanagan,* 352 F.2d 1005, 1008 (1st Cir. 1965); *John Irving Shoe Co.* v. *Dugan,* 93 F.2d 711 (1st Cir. 1937). This is especially so here in light of the strong evidence presented by the government agent as to the questionable trustworthiness of the register. Though taxpayer states that over $130,000 of the expenses listed in the register were not taken as business deductions, and that the sum total of personal expenses testified to by the agent was slightly over $41,000—well within the unclaimed amount—we are troubled by the inability of anyone to say what expenses of those listed were actually deducted and why, in the first place, the personal expenses were in a register clearly labeled as Yuna project expenses. Only the production of the primary records can overcome the substantial shadow which has been cast upon the reliability of the register.

Complicating the issues in this case is the fact that prior to this last retrial stage of the proceedings, the parties had stipulated that the retrial would be on "all the evidence

adduced" at the first trial with the relevant exception here that the government could utilize "such relevant testimony of [its agent] concerning the records of [taxpayer] which were recovered from the Dominican Republic after the prior trial. . . ." Taxpayer interprets this stipulation as prohibiting the motion to strike the register, especially since he alleges that under the stipulation, he could not introduce any additional evidence of the Yuna deductions which might inhere in the primary records in question.

Whatever might have been the result had no exception clause been included in the stipulation, we do not think that in its present form it precludes the government's motion to strike. The clear exception for the testimony of its agent leaves the door open to the government to make whatever motion, procedural, evidentiary or otherwise, which might logically follow as a result of the new testimony. *Cf. Randolph* v. *Missouri-Kansas-Texas R. Co.*, 100 F. Supp. 139 (W.D. Mo. 1951). Moreover, if the stipulation were found to allow only the government to introduce evidence of the primary records for impeachment purposes, and taxpayer were precluded from introducing the remainder of the primary records to substantiate his claim, taxpayer could request the district court, in its discretion, to relieve him of the stipulation. *See, e.g., Central Distributors, Inc.* v. *M.E.T., Inc.*, 403 F.2d 943 (5th Cir. 1968).

Although we have found that under the present circumstances, the register should have been stricken from the record, we do not suggest that the register may not ultimately be admitted into evidence or that taxpayer will be bring his documents to Puerto Rico, *Flanagan, supra,* 352 F.2d at 1008-1009, or to make other arrangements for access consistent with his burden. Moreover, we are uninpressed with the government's evidence thus far as to the Yuna contract. The actual construction site was never visited, and unlike the customs house project, this project was abruptly forced to a halt with attendant problems which are not found in fully completed projects. We do not, of course,

resolve the question of the propriety of the Commissioner's assessment here, assuming that on remand, the imposition of the burden of proof on the taxpayer will result in a more satisfactory evidentiary basis for a finding.

IV. Depreciation and Theft Loss Deductions

A. Depreciation

The taxpayer claimed and the district court found that the taxpayer was entitled to deductions of $130,338, for each of the years from 1960 through 1965 for depreciation primarily of a graving dock, a dredge, and several ships. The court also found that because of these deductions, the taxpayer sustained a net loss in those tax years, which losses may be carried back two years and forward five years from the year in which the losses were sustained, pursuant to 26 U.S.C. § 172. Because of these carry-back provisions, the taxpayer was able to offset all of the few items of income found by the district court (the Escambron constructive dividend and the New York bank account interest) except for the $432 of self-employment taxes held due for the years here at issue.

The government claims that the taxpayer failed to carry his burden of proving by competent evidence his costs and ownership of the assets for which depreciation is claimed. The taxpayer claims that he did meet that burden and that the court's findings regarding depreciation deductions was supported by the record and not erroneous. Although the briefs here, the relevant parts of the record, and even the brief section of the district court opinion on depreciation suggest to us that in fact the parties were proceeding as to this issue on the correct assumption, i.e., that the taxapayer had to establish his deductions, we leave it, as we stated earlier, for the district court to decide whether in fact the parties presented evidence on a proper understanding of the distribution of their proof burdens and if so, to restrict its decision on remand to the existing record.

Though we remand for reconsideration, it is appropriate to discuss the government's major evidentiary and legal arguments at this juncture. This requires a brief statement of the existing record on point. Taxpayer introduced in evidence a depreciation schedule for the relevant assets providing the yearly figure of $130,338. This had been prepared by his accountant in 1970. Testimony revealed that this schedule was prepared, as to the dredge and ships, from the taxpayer's testimony at the first trial, supplied to the accountant by his attorney; and, as to the graving dock and accompanying equipment, from the taxpayer's own written estimate in 1959 of the costs of those assets, which was also a taxpayer exhibit. Despite arguably contradictory testimony, the taxpayer at both trials ultimately asserted that these were estimates of costs, not value in later years. Regarding ownership of the assets, while taxpayer admitted that the full cost of the dredge was originally loaned to him by dictator Trujillo, he testified, albeit after unresponsive answers, that he repaid the first third in the years before 1958 and the remainder in 1961, out of payments made to him in that year on various other contracts. As to the graving dock, he testified and still claims that there was an arrangement under which the government would provide the land and he would construct the dock and then transfer all of the property to a Dominican company which he would organize and capitalize at $3,000,000—of which shares worth $25,000 were to be given the government in payment for the land and the remainder to taxpayer. He explained that because of political conditions and the seizure of his assets, the company was not organized and the transfer made until 1970, at which time he was "proceeding" to issue the promised stock to the Dominican government.

The government's primary complaint is that while the taxpayer has recovered his records, he produced none to substantiate his claimed costs and repayment of the alleged loan for the dredge. Again, as with the Yuna contract expenses, the argument has force. The depreciation schedule

and the taxpayer's cost estimate for the dock are merely summary accounts of the original records of the actual costs of the listed assets. Both the taxpayer and his accountant testified that at least some records relating to these assets were extant and in his possession in the Dominican Republic. The government agent testified that there were eight filing cabinets and numerous boxes of checks, vouchers, contract copies, deposit slips, bank statements and other similar records at the graving dock. For the reasons we have previously noted, the taxpayer's schedule and estimate are admissible only if the underlying original records are made more available to the government. Indeed, as to these documents, production at the trial might be necessary, because the accountant testified that he had not seen any records in preparing the schedule, that he had originally refused taxpayer's counsel's request to prepare such a schedule precisely because of the absence of such records, and acceded only after insistence by counsel that he make an attempt based on the first trial testimony of taxpayer, the written estimate, and conversations with taxpayer. Since we find that the district court improperly admitted the schedule and estimate without requiring production, or at least greater availability, of the voluminous underlying documents, the taxpayer must be given an opportunity to meet the prerequisite to admission of those documents, even if the record is otherwise restricted. *Flanagan, supra*, 352 F.2d at 1008-1009. If the prerequisite is not met, the taxpayer will necessarily have failed to carry his burden of proof as to all but the dredge and ships. As to those, there is the taxpayer's oral testimony, the credibility and hence sufficiency of which we cannot properly decide in the first instance.

The government also claims that under the taxpayer's own description of the arrangement for establishing a company to own the graving dock, he was not the owner and could not claim its depreciation as a deduction against his personal income. In this regard, we note that the only

evidence presently is that the company was not formed until 1970. Thus, it would appear that in the relevant years the company was not the actual owner. However, the government asserts that incorporators and promoters of corporations in the process of formation are fiduciaries *inter se*, as in a joint venture, as well as fiduciaries for the organized corporation, citing hornbook law. It also argues that taxpayer is not entitled to the depreciation deductions because the test is whether the claimant suffers an economic loss because of the decrease in value of the property due to depreciation, 4 Merten's Law of Federal Income Taxation § 23.06; *Weiss* v. *Wiener*, 279 U.S. 333 (1929), and he could not have suffered any such loss since he ultimately received exactly what he bargained for—i.e., all of the stock in the company to which the depreciable assets were transferred, but for the $25,000 worth to be given the government in payment for the land. We do not resolve these claims, both because they were apparently not pressed below, the government raising them only in light of the taxpayer's brief here, and because there are no factual relevant to these issues.

We believe, however, that the first argument is irrelevant and the second inaccurately formulated. As the Court has long held, depreciation deduction are available not only to the legal title holder of the assets. *Helvering* v. *Lazarus & Co.*, 308 U.S. 252 (1939) and cases cited therein. It thus matters not whether taxpayer held legal or equitable title in the relevant years, or whether he held title for his own business or as fiduciary of a company he was jointly promoting. The relevant test is whether taxpayer suffered actual and present rather than theoretical or anticipated economic loss from the depreciation of the assets in the years for which the deductions are claimed. *Weiss* v. *Weiner, supra.* In this regard it would seem unimportant whether he got in stock what he originally bargained for with his joint venturer. The relevant inquiry would seem to be whether as a result of the planned and later actual

organization of the company, or for any other reason, taxpayer, in the years 1960-1964 suffered any economic loss from the depreciation of the assets in those years.

B. Theft Loss

The taxpayer also claimed and the district court found a theft loss deduction in the year 1962 for the dismantling and removal by thieves of all of the materials and equipment other than the hull constituting the "floating hotel," built by the taxpayer to house workers on the Yuna contract. At the time of the alleged theft, the "hotel" was in the control of the sequestrator. The government claims that the taxpayer has failed to carry his burden of proving the fact and the year of discovery of the theft and the amount of loss therefrom. The only statements by the district court relevant to this issue were a comment in the discussion of the Yuna contract that "To house the workmen taxpayer built a floating hotel the construction of which cost $90,000.00," 331 F. Supp. at 537, its ruling that "The loss in 1962 of the floating hotel through dismantling and theft of the materials of which constructed and the equipment installed therein constitutes a loss in 1962 and deductible under 26 U.S.C. § 165(a) and (e).", *id.* at 543; and a finding that the taxpayer's efforts at recovery on the claim had been unsuccessful. Because of our ruling on the burden of proof, and the incompleteness of the court's findings on this matter, we remand for reconsideration. If the record is not to be supplemented, because the taxpayer proceeded under a proper understanding of the burden of proof, we hold that he has failed to carry his burden in this regard and that the loss deduction for 1962 must therefore be disallowed.

The evidence supports a finding that in 1962, soon after the seizure of the taxpayer's property, unauthorized persons dismantled and removed all of the equipment and material constituting the floating hotel other than the barge on which it was constructed, which was returned

to the taxpayer in 1966. The court's findings that the hotel, not including the barge, cost the taxpayer $90,000 to construct, is supported by the taxpayer's initial testimony to that effect, even though that was the highest of three estimates he gave. There was no specific discussion of the dates of its construction, but the taxpayer now argues in his brief, based on various other circumstances, that it must have been completed prior to April 1, 1961, It is enough to say, and we are certain neither side would quarrel with this, that the hotel must have been constructed in some year prior to 1962. There was also no testimony as to the fair market value of the hotel, not including the barge, immediately prior to the theft. Though there was testimony that the theft occurred soon after the government seizure of the assets and that the taxpayer remained in the Dominican Republic for some five or six months after the seizure, there was no testimony as to the year when this theft was discovered by the taxpayer. Finally, while at one point, in 1965, taxpayer testified that a claim for this loss was pending in the Dominican courts, he later claimed that no recovery for such items was possible through the courts, in part because judgment could not be had against the government absent its consent, and that the only hope was, as the district court found, through diplomatic proceedings, which have now allegedly been pending without result for ten years.

The law on point is clear. A theft loss "shall be treated as sustained during the taxable year in which the taxpayer discovers such loss," 26 U.S.C. § 165(e), not the year in which the theft actually occurs, unless the two years are the same. 26 C.F.R. § 1.165-8(a)(2). However, "if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery," the loss is not deductible until the year in which the possibility of recovery "can be ascertained with reasonable certainty." 26 C.F.R. § 1.165-1(d)(3). The amount deductible is the lesser of either the "fair market value of

the property immediately before" the theft or "the adjusted basis" as determined under 26 C.F.R. § 1.1011-1, except that if the property is used in a trade or business and the fair market value before theft is less than the adjusted basis, the latter shall be treated as the deductible amount. 26 C.F.R. § § 1.165-7(b)(1); 1.165-8(c).

Here there was no finding as to the year of discovery, nor was one possible in light of the lack of evidence in the existing record. Moreover, while the court recognized, as the uncontradicted evidence indicated, that the taxpayer had a claim for reimbursement for this loss pending, it did not make a finding as to whether that claim "existed" in the year of discovery, and there is presently in the record only evidence that the claim was pending in 1965. Further, although the court stated that any recovery on the claim would have to be obtained through diplomatic proceedings and that as of the writing of that opinion the taxpayer "has been able to recover nothing although the United States Department of State has been assisting him in his efforts," 331 F. Supp. at 543, it did not determine nor could it have given the record, whether the claim, if pending in the year of discovery, had then "a reasonable prospect of recovery" or in what year the likelihood of recovery could be "ascertained with reasonable certainty." Lastly, though the court found that the cost of construction was $90,000, it made no determination as to the fair market value immediately before the theft, or as to the adjusted basis, or whether the former was less than the latter. The taxpayer on appeal asserts that the hotel was a unique item, not bought or sold in any market, that it therefore had no market value and consequently the cost measured its value to the taxpayer. We note, without accepting the theory,[10] that this is a

[10] We doubt whether one can fairly say that an item has no "fair market value" simply because it is not a frequently or regularly traded commodity. While there is no existing market for or even frequent sale of ocean liners, we note that the Queen Elizabeth I

matter for proof, as to which the taxpayer, of course, bears the burden. If the record is to be reopened, the taxpayer must bear the burden of proof, and the court must make findings, as to all of these requisite factors. If the record is not reopened, the deduction for theft loss in 1962 must be disallowed, the taxpayer having completely failed to carry his burden as to several necessary elements of the deduction.[11]

V. Fraud

The government sought to impose a fraud penalty on taxpayer for underpayment of taxes in 1959 and 1961. We have found it difficult to follow much of the government's brief on the factual matters involved in this aspect of the controversy, and thousands of pages of raw appendix also proved of little help. We take it, however, that as to 1959 the fraud penalty is alledged on appeal to be due as the result of a deficiency from failure to report as income certain constructive dividends from the Escambron Development Company and profits from the operation of two steamships. The district court, having found the Escambron dividends to be income, and apparently not having concerned itself with the two ships, looked only to the dividends issue and found that there was no fraud as to that item. As to 1961, the fraud penalty is alleged on appeal to be due as the result of a deficiency from a failure to report as income the $1,552,000 payment

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was found to have some value when placed on the auctioneer's block. Indeed, even if there were no buyer for a floating hotel as such, the beds, chairs, dressers, and other objects which constituted the hotel obviously had some market value. Even if we were to assume that in some cases there is no "fair market value" for an item or its subdivided parts, the relevant figure would then be not the cost but the adjusted basis, which normally requires deductions from cost for depreciation. *See* 26 U.S.C. § § 1011, 1016.

[11] The last issue, other than fraud, properly raised on appeal is the credence to be given the taxpayer's entire testimony. Obviously credibility is for the factfinder, not a reviewing court. *Mendez* v. *Mendez*, 176 F.2d 849 (1st Cir. 1949).

on the Boca Chica contract, interest derived from New York bank accounts, profits from the operation of two steamships, and from the improper deduction of expenses relating to the Yuna contract. The district court, having rejected the government's assessments of deficiency on all claims but that relating to the bank account interest and again apparently not having concerned itself with the two ships, looked solely to the bank account interest and found no fraud.[12]

When the government seeks to impose a fraud penalty pursuant to 26 U.S.C. § 6653(b), it has the burden to prove by clear and convincing evidence that some portion of the understated tax liability was a product of fraud. *Worcester, supra*, 370 F.2d at 717. "An essential condition to imposition of the fraud penalty is that there shall be a tax liability; therefore, the Commissioner will not be

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[12] In its appeal brief the government relies, *inter alia*, on (1) its agent's discovery of a failure to report income from the ships Rio Haina and Puerto Trujillo in 1959 and 1961 and (2) the improper deduction of personal expenses which were claimed by taxpayer to come under Yuna contract expenses in 1961. We are uncertain as to the relevance of these facts here since we find no indication that the district court was wrong in saying that the fraud penalties were not bottomed on unreported gross income (or improper deductions) shown by that portion of taxpayer's records later taken by government agents which revealed these acts, 331 F. Supp. 544; and as to expenses claimed on the Yuna contract, it appears that in its opening statement in 1966 the government disclaimed the presence of any fraud. We are also unsure whether the liability for self-employment taxes in 1959 and 1961 and the alleged 57.5% profit on the Azua and customs house contracts are relied upon as a basis for fraud. As to the former, there was no mention in the government's opening argument in 1966, and while there was such mention as to the latter, it is not addressed in the government's appeal brief. Lastly, we do not know whether the allaged 57.5% profit on the Yuna contract is relied upon, on appeal, to show fraud. It is obvious that upon remand it is imperative that the government make it clear as to which items fraud is, and can properly be, claimed.

sustained in his assertion of the penalty where he fails to show that an omitted item is income", 10 Mertens, *supra*, § 55.10 at 52 (1972), or that unallowable deductions were taken. *Id.* at 88. In the instant case, since the district court had determined that, as to the omitted items in 1959, only the Escambron dividends were income, and that, as to the omitted items in 1961, only the bank account interest was income, it did not consider the alleged fraud surrounding other omissions or commissions. As we have stated, many of these items, including the Azua, customs house, and Yuna contracts may again be the subject of further district court proceedings upon remand. Thus the tax years 1959 and 1961 will not be closed until the alleged deficiencies relating to every item relevant to each year are resolved. Should the government prevail on any of the claims to be further adjudicated and should there be ultimate tax liability for the year, the district court must, of course, consider the question of fraud as to those claims. "If any part of the deficiency was due to fraud the 50% penalty applies to the entire deficiency, not just the part produced by the fraud." *Worcester, supra,* 370 F.2d at 717 n. 4. Thus, at this juncture, we consider it unnecessary to review the district court's decision on the issue of fraud.

We deem it advisable, however, to comment specifically on the 1961 Boca Chica payment. We have found that, as a matter of law, that payment should have been included as gross income. If, after the year 1961 is closed, there occurs a deficiency due in part to this omission, the court should consider the issue of fraud as to Boca Chica *solely* on the record heretofore established regarding that payment. It was clear to all that, as to fraud, the government properly had the burden of proof and the parties must be deemed to have planned their cases accordingly.[18]

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[18] We leave to the district court, for example, the government's claim that taxpayer did not explain his omission of the Boca Chica payment, which the United States suggests establishes fraud under

VI. Summary of Disposition

On remand the court shall first determine whether the taxpayer reasonably relied on what we now say was an erroneous view of the burden of proof. As to this initial issue, the taxpayer has the burden. As we have said, the court may determine this from the record, together with such briefs as were submitted. If the court deems it either necessary or helpful, it may hear the parties. If the court finds that the taxpayer relied—and was reasonable in relying—on the principle that the government bore the burden of proof, it shall allow the record to be supplemented by both parties.

In any event the record may be supplemented by available primary evidence bearing on the Yuna contract and the depreciation deductions, which, if not done, leaves taxpayer as to all but the dredge and ship depreciation issues with no admissible evidence so that the government must prevail. There is no need for reconsideration of the status of the $1,552,000 Boca Chica payment in 1961; we have already determined that this amount is to be included in gross income for that year. If the record is not to be supplemented, we rule that taxpayer has not, as a matter of law, carried his burden as to the Azua and customs house items or the theft loss deduction. If and when a deficiency has been determined for one or both of the tax years, the court shall then, placing the burden on the government, determine whether fraud on the part of the taxpayer has been proven.

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the rule in *Woodham* v. *Commissioner*, 256 F.2d 201 (5th Cir. 1958), which we think is applicable here.

Similarly, as to fraud involved in Boca Chica and the other claims, should they prove pertinent, we are confident that the trial court will fully hear all arguments with respect to the relevancy of the fact that taxpayer's accountant, working from information supplied by taxpayer, prepared the return. *See, e.g., Bender* v. *C.I.R.*, 256 F.2d 771 (7th Cir. 1958); 10 Mertens, supra, § 55.10 at 64.

In the interests of expediting final decision and of conserving judicial time, the court may, if it sees fit, appoint a special master to receive evidence and report the same together with recommended findings. The parties are encouraged to enter into stipulations which would expedite the resolution of this litigation without prejudice to either side.

Judgment vacated; case remanded to the district court for further proceedings consistent with this opinion.